Policies adopted under duress: A model of fiscal-policy responses to financial crises

With application to Eurozone politics and policies following the 2008 financial crisis

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Abstract

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The present study proposes a model, termed the hybrid model, to explain fiscal-policy responses to financial crises. Although it is applied throughout the present study to the Eurozone, the model's geographic and substantive scope apply more broadly. Combining and building upon past approaches, the hybrid model proposes three independent variables: partisanship, political capacity, and external actors. The model builds on the literature's three dominant approaches: partisan, domestic approaches; approaches that emphasize convergence; and approaches that emphasize divergence, represented here primarily by the Varieties of Capitalism (VoC) literature. The hybrid model integrates the domestic emphasis of the partisan approach with the international emphases of the convergence and, to some extent, VoC approaches. The hybrid model builds on the domestic politics of the partisan approach by integrating coalition logic and the tension between coalition partners into the partisan approach's political landscape. The model also advances the convergence and VoC approaches by providing an explanation for variation in the pressure of financial markets, both over time and across countries, which mediates the influence of external actors in the domestic affairs of sample countries. In addition, with respect to the dependent variable, the present study develops a disaggregated measure that accounts for the diverse distributional implications of fiscal policies' various dimensions.

With respect to empirics, the present study employs a combination of quantitative and qualitative methods. Broadly, the large-N results provide support for the hybrid model, particularly as it pertains to partisanship. Event analyses and case studies support the role of external actors; the empirics show the degree to which financial-market pressure mediates the

influence of external actors. Combined, the quantitative and qualitative approaches indicate problems with consonance, the particular dimension of political capacity considered in the present study. Both quantitative and qualitative results reveal that consonance, i.e., between-party tensions in coalition governments, provides an incomplete characterization of the factors influencing the political capacity of single-party and coalition governments. The case studies suggest that within-party tensions and party-system strength, as additional measures of political capacity, play key roles in shaping fiscal-policy responses. The empirics also confirm the importance of disaggregating fiscal policy, the dependent variable, beyond the broad measures of fiscal deficit, expenditure, and revenue adopted in the present literature.

Contents

Chapter 1: Introduction and theory

Outline of chapter

Chapter 1 is divided into four sections. The first introduces the relevant literature and theoretical debates from which the proposed model, referred to as the hybrid model, emerges. The second section introduces the study's scope conditions. The third section introduces the study's three independent variables: partisanship, political capacity, and external actors. This section discusses the hypotheses over each that emerge from the hybrid model. In doing so, the section introduces the varieties of fiscal policy employed in the present dissertation. The fourth and final section outlines the dissertation's remaining chapters, focusing on how they relate to, build on, and test the hybrid model presented in Chapter 1.

Literature review

Explaining variation in fiscal policy is a particularly difficult issue. Explanations can be roughly broken into two categories: economic and political. Economic arguments explain variation as function of economic efficiency. That is, the analyses consider an economic space and explain how the status quo is economically efficient relative to the alternatives. These analyses rely on there being a known, socially efficient policy. Such a condition exists in the case of the movement of goods and services: free trade.[1] Explaining trade regimes thus amounts to an explanation for divergence from the efficient, free-trade regime. This is the broad approach taken by the literature related to the political economy of trade.[2] In fiscal policy, unlike with respect to trade policy, there is not a known socially efficient policy. For example, the socially optimal

[1] Free trade is identified as the socially efficient outcome as early as Adam Smith. David Ricardo refined Smith's thesis to trade based on comparative, as opposed to absolute, advantage.
[2] Grossman & Helpman (1992) provides one such example. The authors propose a models of trade protection as a function of politicians' private and public interests. To the degree that private interests increase in importance, the politicians provide socially suboptimal levels of free trade.

income-tax rate regime, given market imperfections that are widely recognized by economists, is not known. Similar logic applies for consumption-, payroll-, and corporate-tax regimes. Thus, arguments couched in terms of economic efficiency, particularly of the economic efficiency of entire fiscal regimes, are inherently political. Crucially, fiscal policies and fiscal-policy regimes succeed not because they are economically efficient but because they are advocated by politically successful actors under a particular set of circumstances. One of the dissertation's goals is to examine the characteristics of successful actors and to determine the role of the wider political and economic context in explaining their levels of relative success.

Unfortunately, political explanations for fiscal policy have not progressed far beyond basic partisan models of taxation and spending, presented here broadly under the rubric of domestic, partisan approaches. In these models, voters are arrayed along a left-right spectrum. Preference for taxation decreases with rightward movement along the continuum. The first models to explicitly incorporate politics and fiscal policy arose in the literature on the political business cycle, first proposed by Nordhaus.[3] Nordhaus proposed a contested tradeoff between inflation and unemployment, over which political actors exhibited varying preferences. Nordhaus's empirics concludes that incumbent terms begin with policies of relative austerity (defined as reduced spending and increased taxation) that shift into periods of largesse prior to elections. From the perspective of the present approach, Nordhaus's conclusion is apolitical, hypothesizing no differences in preferences between political parties. Hibbs advanced Nordhaus's work in two principal manners.[4] First, Hibbs provided an empirical test of Nordhaus's theory by analyzing the behavior of post-World War II, developed economies.

[3] Nordhaus, William D. "The political business cycle." *The review of economic studies* (1975): 169-190.
[4] Hibbs, Douglas A. "Political parties and macroeconomic policy." *American political science review* 71.04 (1977): 1467-1487.

Second, in a move germane to the present research agenda, Hibbs incorporated political preferences of economic outcomes and thereby politicized the technocratic process initially conceptualized by Nordhaus. Hibbs concludes that postwar governments fall into two broad camps: low unemployment-high inflation countries typically governed by the left and high unemployment-low inflation countries governed by the right. Hibbs analysis thus identifies variation in the cross section but not the time series. Alesina, Roubini & Cohen, an exemplum of the subsequent generation of political business cycle models, proposes a model that permits variation within countries over time and finds significant partisan effects with respect to both inflation, unemployment and the deficit.[5]

From the perspective of broader fiscal-policy analysis, the political business cycle suffers from a number of key shortcomings. First, the macroeconomic aggregates that serve as the literature's dependent variables are too highly aggregated for the context of political debate. Politicians debate the policy components that aggregate upwards and ultimately produce the deficit; they do not select the deficit directly. While politicians have some degree of influence of inflation and unemployment, they do not select these values directly. Second, the politics of even the more sophisticated approaches advanced by the political business cycle literature are rudimentary. This reflects both a lack of theoretical vision as well as dependent variables over which parties do not compete directly.

From the literature on the political business cycle, two strands of literature relevant to explaining fiscal-policy variation emerged: the expansionary austerity literature and the convergence literature. In an early paper, Alesina, Perotti & Tavares argued that not all austerity,

[5] Alesina, Alberto, Nouriel Roubini, and Gerald D. Cohen. *Political cycles and the Macroeconomy*. MIT press, 1997.

defined as a reduction in the fiscal deficit, reduces growth.[6] The authors argued that, while tax increases reduce growth, spending cuts that emphasize public-sector wages and transfers increase growth. In one of the first explorations of partisanship in the literature, the authors find little effect of partisanship on either the adoption of austerity measures or their eventual success, defined as leading to the policies' remaining in place over the medium-term. Over the next ten years, several papers told a similar story; these papers formed the theoretical and empirical basis for the IMF's position on fiscal-policy reform in recipient countries.[7] In one of the final papers to defend the notion of expansionary austerity offered by Alesina, Roberto & Tavares, Alesina & Ardagna examine large fiscal adjustments and reinforce the prior findings in the literature.[8] It is to this paper and the wider literature that Guajardo, Leigh & Pescatori (2014) directly respond.[9] The authors argue that the literature on expansionary austerity fails both theoretically and empirically. The authors show that, contrary to what the prior literature suggests, both expenditure- and revenue-centric austerity reduce growth in the short-run.

The paper proved particularly important because of the formal participation of the IMF's research department. The shifting position of the IMF proved crucial to the opening up of the bargaining space between bailout recipients and the Troika. Because of the outsized importance occupied by the changes in the IMF's preferences in the evolution of fiscal-policy response to the 2008 crisis, subsequent chapters explore not only the IMF's gradual rejection of expansionary austerity but also the reasons underlying the IMF's evolution. A sub-literature

[6] Alesina, Alberto, Perotti, Roberto and Jose Tavares. "The political economy of fiscal adjustments." *Brookings Papers on Economic Activity* (1998): 197-266.
[7] Alesina, Alberto, Silvia Ardagna, Roberto Perotti, and Fabio Schiantarelli. 2002. "Fiscal Policy, Profits, and Investment." *American Economic Review*, 92(3): 571-589.
[8] Alesina, Alberto, and Silvia Ardagna. "Large changes in fiscal policy: taxes versus spending." *Tax Policy and the Economy, Volume 24*. The University of Chicago Press, 2010. 35-68.
[9] Guajardo, Jaime, Daniel Leigh, and Andrea Pescatori. "Expansionary austerity? International evidence." *Journal of the European Economic Association* 12.4 (2014): 949-968.

emerged to explore precisely this evolution. Some authors argued that the Washington Consensus formed a stable basis for the IMF's fiscal-policy preferences.[10] In general, these arguments for stability relied mostly on the broadly consistently neoliberal emphasis of the IMF's policy prescriptions. A separate set of authors look at variation within the set of neoliberal policies prescribed. These authors contend that, in the early 2000's and after the onset of the 2008 financial crisis, the IMF's fiscal-policy preferences and recommendations evolved in important and systematic ways.[11] While frequently framed as diametrically opposed, the competing bodies of literature on the IMF's policy preferences can be reconciled by thinking about the IMF's policy advice as remaining well within the boundaries of the neoliberal policies prescribed by the Washington Consensus, with limited evolution in a select number of policy areas, including with respect to capital controls and fiscal policy. Gallagher describes the evolution of the former that occurred during and following the IMF-coordinated responses to the Latin American debt crisis in the 1980's and the East Asian financial crises in the 1990's.[12] In contrast to the mandatory and complete capital-account liberalization advocated by the IMF in the 1980's and 1990's, the revised view placed less emphasis on rapid and complete liberalization. Indeed, the view advocated for capital controls in some limited instances. In the context of the European financial crisis, the reform view became important in, *inter alia*, Cyprus, Greece, and Ireland. With respect to fiscal policy, the IMF's position gradually evolved

[10] Gabor, Daniela. "The International Monetary Fund and its new economics." *Development and Change* 41.5 (2010): 805-830 & Babb, Sarah. "The Washington consensus as transnational policy paradigm: its origins, trajectory and likely successor." *Review of International Political Economy* 20.2 (2013): 268-297.
[11] Broome, André. "The International Monetary Fund, crisis management and the credit crunch." *Australian Journal of International Affairs* 64.1 (2010): 37-54. & Lütz, Susanne, and Matthias Kranke. "The European rescue of the Washington Consensus? EU and IMF lending to Central and Eastern European countries." *Review of International Political Economy* 21.2 (2014): 310-338.
[12] Gallagher, Kevin P. "Contesting the Governance of Capital Flows at the IMF." *Governance* 28.2 (2015): 185-198.

throughout the 2000's and early in the crisis period. Broome[13] and Ban[14] document this evolution. The former considers fiscal policy within the broader context of the IMF's policy advice and shows that fiscal policy is one of a limited number of areas in which the Fund demonstrated substantive change. Ban describes how the gradual rejection of expansionary austerity occurred as a result of a confluence of factors. A receptive Managing Director, Dominique Strauss-Khan, hired economists sympathetic with a neo-Keynesian framework. These economists, crucially, were able to undermine the basis of expansionary austerity with the kind of models required for credibility in macroeconomic policymaking and academic circles. This is the approach taken by Guajardo, Leigh & Pescatori in their successful and influential rebuttal of Alesina's doctrine of expansionary austerity.

As discussed above, two strands emerged from the literature on the political business cycle. The first, as already discussed, involves the doctrine and eventual repudiation of expansionary austerity. Second, discussed below, involves what has been called the convergence approach. The convergence approach represented the academic analog to a transnational policymaking community dominated by the Washington Consensus. With governments on both the left and the right seemingly adopting similar policies, represented by the rise of "third-way" candidates such as Labour's Tony Blair in Great Britain and the Democrat's Bill Clinton in the United States, policy ostensibly converged to a neoliberal paradigm, characterized by limited government involvement in economic decisionmaking. This view was seemingly reinforced by the limited partisan effects identified in the political business cycle literature.[15] Models in the

[13] Broome, André. "Back to basics: the great recession and the narrowing of IMF policy advice." *Governance* 28.2 (2015): 147-165.
[14] Ban, Cornel. "Austerity versus Stimulus? Understanding Fiscal Policy Change at the International Monetary Fund since the Great Recession." *Governance*28.2 (2015): 167-183.
[15] For a representative example, see Alesina, Perotti & Tavares (1998).

convergence literature frequently followed Meltzer-Richard's approach to left-right partisan competition. In this competition, capital mobility is crucial, since it provides capital owners the ability to withdraw taxable resources (e.g., stocks and bonds) from the domestic economy; in these models, capital mobility drives down the equilibrium tax rate. It is this notion of "footloose" capital that Rodrik[16] and Garrett[17] seize upon in their discussions of policy convergence among developed economies; this insight forms the theoretical basis from which the convergence approach emerges. In a world populated by states competing for footloose capital, the convergence school predicts capital-tax rate convergence across countries at trivially low rates. Although the logic is strained, primarily because of limited factor mobility, similar arguments apply to taxes on consumption, income, and payroll. It was this proposed convergence that formed the basis of the neoliberal Washington Consensus.[18]

At the same time that the convergence approach gained prominence, a competing vision of divergence emerged. In contrast to the convergence approach's focus on the relatively liberal economies of Great Britain and the United States, the divergence strand emphasized continental Europe. Katzenstein considers how the small western European economies remain competitive within the global economy without losing all market share to either lower cost areas such as East Asia or the more lightly regulated Anglo-Saxon economies.[19] Following Katzenstein, Cameron presents welfare-state spending and transfers as a response to citizen demands, as economies become more exposed to economic competition.[20] The early literature, however, fails to offer a

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[16]Rodrik, Dani. "Sense and nonsense in the globalization debate." *Foreign Policy* (1997): 19-37.
[17] Garrett, Geoffrey. *Partisan politics in the global economy*. Cambridge University Press, 1998.
[18] The Washington Consensus was a term first coined by John Williamson in 1989 and referred to the set of policies advocated by the US and US-dominated international financial institutions following the fall of the collapse of the Soviet Union: Williamson, John. "What Washington means by policy reform." *Latin American adjustment: How much has happened*? (1990): Chapter 2.
[19] Katzenstein, Peter J. *Small states in world markets: Industrial policy in Europe*. Cornell University Press, 1985.
[20] Cameron, David R. "The expansion of the public economy: A comparative analysis." *American political science review* 72.04 (1978): 1243-1261.

compelling vision of why welfare-state economies can maintain high levels of spending, given the convergent pressures identified by the convergence approach. The varieties of capitalism (VoC) literature, which springs from the early work of Esping-Andersen, offers one nascent explanation for the persistence of large welfare states in competitive global markets.[21] Esping-Andersen delineates three varieties of capitalist economies, which prefigure the dichotomy proposed by Hall & Soskice. Hall & Soskice describe two types of capitalist economies: liberal market economies (LME's) and coordinated market economies (CME's). [22] In the former, market competition facilitates coordination between actors; in the latter, the government and major economic actors coordinate activity in order to manage market forces. The US and the UK provide prototypical examples of LME's; most continental European countries operate as CME's. Theoretically, the anticipated fiscal policies in these respective regimes differs. In LME's tax burdens are relatively low, as the market autonomously coordinates the actions of economic actors; in CME's, where the burden of coordination lies with the government, tax burdens are higher.

Both convergence and divergence approaches propose limited models of domestic politics. The former completely ignores domestic politics; the empirics tend to confirm the theoretical priors of minimal partisan effects. The latter partially incorporates them, but in a relatively unsophisticated manner; in general, divergence models explain domestic policy variation as a function of institutional variation, rather than as a function of the partisan occupation of those institutions. For example, Hall & Soskice emphasize the policy consequences of different labor-market institutions. These institutions, however, are largely

[21] Esping-Andersen, Gosta. *The three worlds of welfare capitalism*. Princeton University Press, 1990.
[22] Hall, Peter A., and David Soskice, eds. *Varieties of capitalism: The institutional foundations of comparative advantage*. Oxford University Press, 2001.

exogenous to the preferences of current politicians. A separate literature attempts to explain variation in policy as a function of partisanship. Such models, inspired by Meltzer-Richard (1981), accounts for some of the variation observed.[23] Meltzer-Richard models, referred to throughout as partisan MR approaches, have difficulty accounting for deflationary regimes adopted by the left, inflationary regimes adopted by the right, and the crucial presence of the Troika, an institution that blends domestic and international features. As an example, consider the broad support, on both the left and the right, for the low level of corporate taxation in Ireland. In negotiating Ireland's bailout in late 2010, the Fianna Fail-Progressive Democrat-Green coalition government refused to increase the Eurozone-low corporate tax rate of 12.5%, despite the complaints of French and German policymakers who decried the unfair competition and race-to-the-bottom dynamic engendered by Ireland's low rate.[24] Similarly, the Fine Gael-Labour coalition that took office in February 2011 refused to change the corporate tax rate in exchange for debt relief.[25] The broad-based support for a low corporate tax rate cannot be explained by an unreformed, partisan MR model. The convergence and VoC schools also have trouble explaining the Irish position, but for different reasons. The convergence literature predicts that countries would converge to Ireland's tax rate, while the VoC approach predicts that the Eurozone economies would cleave along lines related to the strength of labor-market institutions, a dynamic that has not been observed in the Eurozone's country-coalitions following the crisis.

A maturing literature has attempted to incorporate the insights of Meltzer-Richard and partisan conflict into models of budget-making. This literature presents two competing visions of

[23] Meltzer, Allan H., and Scott F. Richard. "A rational theory of the size of government." *The Journal of Political Economy* (1981): 914-927.
[24] "Speech long on aspiration but short on inspiration." *Irish Independent*. 8 December 2010.
[25] "Kenny seeks way to avoid referendum on tough EU rules." *Irish Independent*. 10 December 2011.

budget-making: one based on partisanship, the other based on institutions.[26] While fiscal policy falls within the purview of budget-making, the two are conceptually distinct categories; however, the broad contours of the budget literature, in particular the conflict between partisan and institutional perspectives, speaks to similar approaches with respect to to fiscal policy. Partisan approaches follow Meltzer-Richard in their emphasis on the median voter. Lambertini proposes a model in which socially liberal governments run surpluses and conservative government run deficits in order to capture the median voter.[27] By and large, however, these models do not focus on the composition of the deficit. Tabellini & Alesina provides a partial exception, in which competing parties have differing preferences over the composition over expenditures.[28] The institutional approach, on the other hand, emphasizes the effect of political institutions and budget-making rules on the size of the deficit. Hallerberg, Strauch & Von Hagen describe two varieties of budgeting institutions: delegation and contracts.[29] In the former, a government delegates budgeting authority to a relatively strong finance minister. In the latter, a government contracts between groups of roughly similar power, i.e., parties, govern budgeting negotiations. In a subsequent book that expands on their initial article, the three authors demonstrate that the effectiveness of these systems varies as a function of governing and party system.[30] Where coalition governments include a small number of parties with relatively homogenous policy preferences, the delegation model works best. Where coalition governments include a more

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[26] von Hagen, Jürgen and Rolf Strauch. *Institutions, politics and fiscal policy*. Vol. 2. Springer Science & Business Media, 2000.
[27] Lambertini, Luisa. "On the redistributive property of budget deficits." *Institutions, Politics and Fiscal Policy*. Springer US, 2000. 3-18.
[28] Tabellini, Guido and Alberto Alesina (1990) "Voting on the Budget Deficit", *American Economic Review*, Vol.80, No.1.
[29] Hallerberg, Mark, Rolf Strauch, and Jürgen Von Hagen. "The design of fiscal rules and forms of governance in European Union countries." *European Journal of Political Economy* 23.2 (2007): 338-359.
[30] Hallerberg, Mark, Rolf Rainer Strauch, and Jürgen Von Hagen. *Fiscal governance in Europe*. Cambridge University Press, 2009.

heterogeneous collection of parties, the contract model works. Crucially, the authors fail to explore the degree to which the budgeting system is exogenous with respect to either the political system or the preferences of political actors.

Contributions of the present model

The hybrid model makes several contributions, both theoretical and empirical, to the variety of literatures and sub-literatures discussed above. First, the model's inclusion of three important sets of independent variables—partisanship, political capacity, and external actors—represents an important theoretical step forward for the literature. Hitherto, the three have not been integrated into a comprehensive framework. In doing so, the hybrid theory mediates between the domestic focus of the partisan approaches and the international focus of the convergence and divergence approaches.

Second, the domestic theoretical components and their empirical analogs in the hybrid model disaggregate the dependent variable, fiscal policy. Some of the problems underlying explanations for fiscal policies in the present literature stem from mis-specified levels of analyses. Political actors do not act at the level of aggregate fiscal policy. Such aggregation leads to analysis that generates preferences over the size of government or the total levels of taxation and spending. By defining preferences at the level of highly aggregated fiscal policies, these models, to a large extent, obscure the role of politics. Where policies are determined by structural factors, as in the convergence school, the left and right converge on the policy implied by competition over footloose capital. In the VoC approach, no variation is expected within the two types of market economies. The present model injects political realism into the study of fiscal-policy reform. It does so by disaggregating the dependent variable and explicitly theorizing the political roots of observed variation in disaggregated policies.

Third, the hybrid model proposes a more realistic vision of domestic politics, in which tensions between coalition partners influence the fiscal-policy trajectory. This vision builds upon the reduced-form domestic politics observed in Meltzer-Richards, Tabellini & Alesina, Lambertini and the descendant literature. Moreover, the dissertation presents an original measure of parties' economic preferences that addresses concerns related to the bluntness of the standard RILE measure. While the dissertation employs manifesto statements rather than adopted policy positions as a measure of party policy preferences, important concerns about strategic revelation and revealed preferences persist. To an extent, these are unavoidable without direct access to the thoughts of senior politicians. Concluding remarks in Chapter 8 discuss a number of potential venues for future research to address the issues raised by strategic revelation of preferences.

Fourth, with respect to the convergence school, the hybrid model emphasizes the circumscribed nature of market pressure as a convergent force. In contrast to the diffuse, decentralized, but ubiquitous pressure at work in the convergence school, convergent pressure arises in the present model from the interaction of sovereign-bond markets and external actors. In this approach, the hybrid model follows the work of Mosley, which distinguishes between sovereign-bond market effects in developed and developing countries.[31] Kaplan advances Mosley's work by exploring sovereign-bond market pressure in Latin America.[32] In contrast to the narratives of Mosley and Kaplan, where bond markets act directly upon domestic politicians, the hybrid model emphasizes the role played by external actors as important mediating actors between the pressures of bond markets and domestic politics. Put simply, external actors with financial resources have the greatest influence when sovereign-bond yields are high and domestic alternatives are limited. Thus, the model provides an explanation for why convergent

[31] Mosley, Layna. *Global capital and national governments*. Cambridge University Press, 2003.
[32] Kaplan, Stephen B. *Globalization and austerity politics in Latin America*. Cambridge University Press, 2013.

pressures vary over space and time, even when sovereign-debt yields remain constant. Importantly, Mosley's and Kaplan's analyses have trouble accounting for such change, because, in their models, policy change is solely a function of sovereign-bond yields and not the preferences and actions of external actors. These actors, however, occupy an increasingly important role in managing and directing crisis-country policy responses. In understanding the evolving role of such institutions, the present dissertation takes as its point of departure the pioneering works of Broome, Ban, and Gallagher discussed in the previous section.

Alternative approaches: Individual country studies and journalistic approaches

There has been surprisingly little academic work conducted on the politics of fiscal-policy responses to the 2008 financial crisis. To date, the best work on fiscal policy following the financial crisis arises in country-specific studies, typically written by journalists. Leahy's work on Ireland traces the collapse of the Fianna Fail-Progressive Democrat-Green government and subsequent tensions within the Fine Gael-Labour government over adjustment policy.[33] Leahy's work does not provide a framework to extend insights to other countries; this is understandable, given his professional and personal interests in Ireland. On other crisis countries in Europe, including the bailout recipients in particular, the Troika routinely releases descriptive work on adopted policies.[34] As part of its continuous monitoring of bailout recipients, the Troika publishes quarterly updates of the economic conditions and policies adopted in recipient countries. The Troika's documentation, as it is almost entirely descriptive in nature, fails to provide either within- or across-country explanations for the variation in policies adopted. Where

[33] Leahy (2009) traces the collapse of the Fianna Fail-Progressive Democrat-Green coalition. Leahy (2013) examines the tensions with the Fine Gael-Labour coalition elected in response to the financial crisis. The full citations, respectively, are as follows: Leahy, Pat. *Showtime: The inside story of Fianna Fáil in power*. Penguin UK, 2009; Leahy, Pat. *The Price of Power: Inside Ireland's Crisis Coalition*. Penguin UK, 2013.

[34] As one example, see Sapir, Andre, et al. *The Troika and financial assistance in the euro area: successes and failures*. Publications Office, 2014.

they attempt to provide such explanations, Troika publications frame fiscal-policy developments as emerging from a dynamic tension between efficient Troika recommendations and inefficient implementation by host-country governments.

Outside of Europe, scholarship on the US-policy response tends to focus on monetary policy, financial institutions, and the inadequacy of regulation prior to Lehman's failure. Lewis describes the policies that produced the financial crisis: a permissive regulatory government in the presence of significant financial-market innovation, coupled with loose monetary policy and political pressure to expand home ownership domestically.[35] Chinn & Frieden takes a similar approach and arrives at similar conclusions.[36] Barofsky describes the implementation of the troubled-asset relief package (TARP), the $700 billion stimulus package approved by President Bush.[37] As Barofsky's narrative makes clear, most of the ostensibly fiscal response embodied in TARP related the funding of banks. While there are bank-related elements to crisis policies adopted in the Eurozone (with respect to Ireland and Spain, in particular), the packages tend to be diverse and more closely related to the real economy than in both the US case in general and TARP in particular. A final author, Kaiser, traces the policy failures purportedly underlying the financial crisis and the passage of the Dodd-Frank Bill, the American response to the financial crisis.[38]

Outside of academic circles and technocratic publications, the financial press provides the majority of coverage. In particular, the *Financial Times* offers regular coverage of crisis

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[35] The full citations, respectively, for Lewis's works most germane to the financial crisis and subsequent policy responses are as follows: Lewis, Michael M. *Panic: The story of modern financial insanity*. WW Norton & Company, 2009; Lewis, Michael. *The big short: Inside the doomsday machine*. WW Norton & Company, 2011.
[36] Chinn, Menzie D., and Jeffry A. Frieden. *Lost Decades: The Making of America's Debt Crisis and the Long Recovery*. WW Norton & Company, 2011.
[37] Barofsky, Neil. *Bailout: How Washington Abandoned Main Street While Rescuing Wall Street*. Simon and Schuster, 2013.
[38] Kaiser, Robert G. *Act of Congress: How America's Essential Institution Works, and How It Doesn't*. Knopf, 2013.

countries; the *FT*'s focus is primarily financial, with a discussion of fiscal policies and politics only insofar as they affect financial markets. In the *New York Times*, authors such as Paul Krugman offer selective and frequent criticisms of the US and European policy responses. Studies of individual countries and daily reporting by financial reporters are particularly strong in tracing the events within individual countries. Where they fail is to provide a general framework with which to explain variation in fiscal policy across countries. The hybrid model presented here provides such an approach.

Scope conditions

The present study draws on evidence from the response of Eurozone countries to the 2008 financial crisis. The countries studied include all Eurozone countries over the period between 2000 and 2013.[39] Since they joined the Eurozone in 2014 and 2015, respectively, Latvia and Lithuania are excluded. The financial press has referred to a specific subset of Eurozone countries as PIIGS: Portugal, Italy, Ireland, Greece, and Spain.[40] After receiving a bailout in 2013, observers added Cyprus to the list. Rather than perpetuating the strong normative impulse underlying the PIIGS acronym, the present study refers to these countries as "crisis countries." The current literature informs the sample used to test the hybrid model in the preset dissertation. Mosley describes how financial markets respond differently to political and economic events in

[39] Eurozone countries with year of Euro adoption in parentheses include Austria (1999), Belgium (1999), Cyprus (2008), Estonia (2011), Finland (1999), France (1999), Germany (1999), Greece (2001), Ireland (1999), Italy (1999), Latvia (2014), Lithuania (2015), Luxembourg (1999), Malta (2008), the Netherlands (1999), Portugal (1999), Slovenia (2007), Slovakia (2009), and Spain (1999). The years listed are those in which the Euro was adopted as a country's accounting currency; for early adopters, there were a number of years between accounting-based and cash-based adoption.

[40] A small constructivist literature looks at the development and consequences of the PIIGS acronym. PIGS (first used in reference to Portugal, Italy, Greece, and Spain) first appeared in the financial press in a *Wall Street Journal* article: Kamm, Thomas. "Snobbery: The latest hitch in unifying Europe—Northerners sniff as 'Club Med' South clamors to join new currency." *Wall Street Journal*. 6 November 1996. For an introduction to the constructivist literature, see Brazys, Samuel, and Niamh Hardiman. "From 'Tiger' to 'PIIGS': Ireland and the use of heuristics in comparative political economy." *European Journal of Political Research* 54.1 (2015): 23-42.

developed and developing countries.[41] Mosley distinguishes between the strength and scope of financial-market reactions. Among countries with access to foreign capital, the main differentiator is scope, which Mosley defines as the breadth of signals used to evaluate the creditworthiness of a potential debtor. Creditors consider a wider range of signals when lending to developing countries; by contrast, creditors consider a narrow range of signals when lending to developed countries. Thus, creditors consider the level of debt and deficit relative to GDP when evaluating creditworthiness; in the context of developing countries, however, creditors also consider the composition of taxation and expenditure. Mosley's study casts the Eurozone economies as developed; creditors thus employ a limited number of indicators to evaluate creditworthiness. The line between developed and developing is arbitrary, and there is no reason *a priori* for any particular Eurozone economy to be classified as either developed or developing. One broad interpretation of the crisis, from the perspective of financial markets, is the gradual devolution of the Eurozone's peripheral economies from developed to developing economies. Thus, a la Mosley's framework, creditors gradually considered a wider range of indicators in their evaluation of peripheral debt and thus reacted more strongly to shifts in composition of taxation and spending late in the crisis period; up to that point, such composition had been ignored, as financial markets treated the peripheral economies as developed. Applied to the Eurozone crisis, however, Mosley's conceptualization of financial markets as impersonal buyers and sellers of debt ignores the crucial role played by the Troika in setting standards and directing crisis-country policy. Indeed, whereas Mosley's narrative would describe financial-market participants as gradually considering a wider breadth of political and economic indicators, the application of the hybrid model in Chapters 4 & 5 suggest that the Troika played an important

[41] Mosley, Layna. *Global capital and national governments*. Cambridge University Press, 2003: 25-49.

and crucial role in guiding financial markets to consider the fiscal composition of crisis countries more carefully.

The Eurozone, which is an important object of study in its own right, presents an illuminating example with which to study fiscal-policy responses to financial crises. The political steps to ensure macroeconomic convergence among a large set of countries constitute an unprecedented step in both political and macroeconomic relations between countries. The unique dynamic created by such a large currency union, without either the banking or fiscal union of federal polities like the United States, created problems of moral hazard and principal-agent accountability. The financial-market implications of the former are explored in Chapter 4's analysis of sovereign bond yields. The fiscal-policy implications of the latter are explored in Chapters 5, 6 & 7, which deal variously with the difficulties faced by the Troika (principal) in shaping policy and economic outcomes in the crisis countries (agents).

In a currency union, where monetary policy is ceded to a supranational central bank, individual countries cannot respond autonomously with monetary policy to macroeconomic developments.[42] Without either monetary policy or exchange-rate interventions with which to respond to either financial or macroeconomic shocks, countries adjust through changes in fiscal policy—this represents the common distinction drawn between external adjustment (devaluation) and internal adjustment (austerity). The Eurozone's limited monetary-policy autonomy of countries within the Eurozone parallels the situation faced by many developed countries; Chapter 8 explores these parallels in greater depth. While countries with independent central banks

[42] Countries can, however, lobby for the adoption of monetary policy change at the supranational level, which in the Eurozone's case is the European Central Bank (ECB). This creates some room for countries to effect monetary policy change. This dynamic implies that the problem with ceding monetary policy authority to a supranational entity is not a problem, in principle, for adjustment to macroeconomic developments. Ceding policy autonomy only becomes a problem when there is substantial macroeconomic divergence among currency-union members. The difficulties posed by such divergence may be compounded by ideological differences between member states that attribute macroeconomic divergence to different causes.

outside of currency unions retain the ability to adjust with either monetary policy or devaluation, the convergence of monetary policies to the nominal zero-lower bound (ZLB) means that countries are increasingly forced to adjust through fiscal-policy. Chapter 5 explores the effects of the ZLB on Eurozone economies in greater depth.

The ZLB thus provides a constraint below which conventional monetary policy is no longer an option. The limits to conventional monetary policy provides the basis for applying the hybrid model to a wider set of countries. The ZLB provides a point of contact between the present model and the situations of the US, UK, and Japan. The situation of these, and other, countries that do not interfere in currency markets at the ZLB approximates the conditions faced by the Eurozone's crisis economies.

Overview of proposed theory

The following schematic attempts to provide an explanation for the fiscal policies adopted by countries during and following financial crises. Figure 1 displays the main independent and dependent variables employed by the hybrid model. The model proposes three sets of independent variables: political capacity, partisanship, and external actors. These variables work in concert to explain variation in the dependent variable, the fiscal policies adopted by countries in response to financial crises.

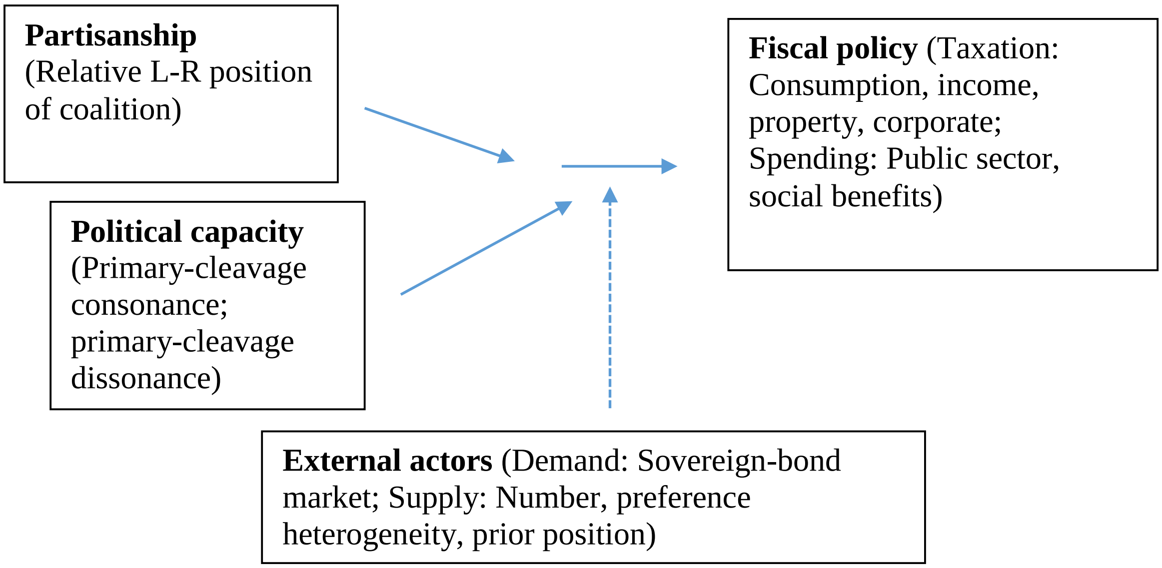

Figure 1. Schematic of the hybrid model's theoretical logic. Variables are listed in bold, additional detail information related to operationalization.

Political capacity constrains the ability of governments to draft and implement controversial legislation. As operationalized in subsequent chapters, the model describes political capacity as a function of policy agreement between parties in government. It does not relate to conflict within parties; Chapters 3 & 7 explore the implications of this modelling decision. The hybrid model differentiates between two types of governments: primary-cleavage consonance governments (PCC's) and primary-cleavage dissonance governments (PCD's). In the former, parties in government largely agree on primary-cleavage policy; in the latter, parties in government disagree on primary-cleavage policy. In the context of financial crises, fiscal policy is assumed to be the primary-cleavage policy. This is plausible in Eurozone economies within the context of financial crises, when economic policy is particularly salient and where monetary policy and exchange-rate adjustment are constrained. Outside of the Eurozone, analogous approaches would need to include a wider range of economic policies, including, but not limited to, monetary policy and exchange-rate interventions.[43] To the extent that political parties have

[43] Examples abound of monetary policy changes and exchange-rate intervention in non-Eurozone countries in response to the 2008 financial crisis. Great Britain provides an example of the former, in which the Bank of England

preferences of particular fiscal outcomes, partisanship influences fiscal-policy outcomes. Whereas previous studies conceptualize parties on the traditional left and the traditional right, the approach taken here develops a nuanced measure of partisanship, derived particularly as it relates to fiscal policy, from party manifestos.

Parties, however, are not able to implement their policy preferences directly. On the one the hand, a governing party is constrained domestically by political capacity and the preferences of current and future coalition partners. On the other hand, a governing party is constrained internationally by external actors, whose preferences over policies, if not outcomes, frequently differ from those of domestic politicians. The dashed line extending from external actors indicates that the constraint is not always binding. The relative influence of external actors depends on both demand- and supply-side conditions. On the demand side, governments resort to external actors when bond yields exceed either their willingness or ability to pay. On the supply side, the domestic influence of external actors varies as a function of the number of external actors, the preference homogeneity of external actors, and the prior position of the external actors in the domestic economy.

Partisanship

The present model distinguishes between parties and coalitions. Parties are sets of individuals, as shown in Figure 2, differentiated by primary sources of incomes: corporate, middle class, public sector, and working class.[44] The groups appear as such when arrayed on a left-right spectrum:

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reached the zero-lower bound prior to the government's implementing wide-ranging austerity. Switzerland provides an example of the latter. In January 2015, the Swiss National Bank (Switzerland's central bank) sold Swiss Francs in order to relieve pressure of the Frank, in response to investors buying the Frank as a relatively safe asset amid global turmoil.

[44] The hybrid model could accommodate a larger set of individuals. Given the pertinent cases, these groups strike a reasonable balance between capturing a large proportion of variation and producing a tractable framework for empirical analysis.

Left ——————————————————————— Right

Working class **Public sector** **Middle class** **Corporate**

Figure 2. Parties aligned along a conventional left-right spectrum.

Coalitions are combinations of parties that form, depending on the circumstances, temporary or permanent alliances to either enter government or pass legislation. In principle, a coalition may include only a single party. This most often occurs with respect to single-party majority governments, as in Spain and Portugal. However, because of majority requirements for the passage of legislation, coalitions typically contain more than one party. Even in Spain's single-party Socialist governments, the PSOE required the cooperation of regional parties to pass particularly controversial legislation. As the case studies of Chapter 6 & 7 underscore, politics in the Eurozone revolves around coalitions.

Figure 2 displays policy preferences along a left-right scale that has been adopted in most of the literature. Partisan MR models produce clear hypotheses about party preferences over fiscal policies. In general, the public sector and the working class favor more spending and more taxes; corporate interests and the middle class, on the other hand, favor less spending and less severe taxes. In contrast to partisan models that take these preferences as given, the hybrid model's policy preferences emerge endogenously as a function of the individual's preference to maximize income. [45] In this framework, the partisan model's left-right preference over tax-and-spend policies is shown not to hold in general. When multiple categories of taxation and spending are considered, parties on the traditional right and left have varying preferences over different categories of fiscal policy.

Hypotheses over partisanship: Preferences over the dependent variable

[45] Hibbs, Douglas A. "Political parties and macroeconomic policy." *American political science review* 71.04 (1977): 1467-1487.

In partisan models, the left favors increased taxes and spending, and the right favors decreased taxes and spending. These models have trouble accounting for a left party cutting spending or a right party raising taxes, actions observed in the years following the 2008 financial crisis. The empirical failure stems from the theoretical failure to account for the varied distributional implications of different taxation and spending measures. Such variation in distributional consequences is the motivating theoretical impulse behind the present model. Because left-right preferences do not arise from ideology in the hybrid model, the left does not necessarily favor more spending and more taxes; likewise, the right does not necessarily favor less spending and less severe taxes. Each of these groups favors policy changes insofar as these changes increase group income.

In the hybrid model, parties seek to maximize the income of their constituencies. The model considers four types of taxation: consumption, income, social security, and corporate. [46] Consumption taxes are taxes on goods and services, excluding real estate, applied at the time of purchase. Examples include value-added taxes, excise taxes, and general service taxes. One feature that makes consumption taxes politically attractive is their rapid translation into revenue, relative to other forms of taxation. Income taxes refer to taxes paid on personal income. Corporate taxes include taxes on corporate income as well as on financial instruments. Thus, capital-gains taxes are included as a subset of corporate taxation. These taxes are not organized as they would be in an accounting text. Rather, they are grouped according to their distributional implications. It is with these implications in mind, rather than the formal accounting definitions, that parties design packages of fiscal policy. Changes in each of these measures produce distinct

[46] With both taxation and spending measures, the model could consider a wider set of policy instruments. As with the analysis of political parties, however, the model must balance the related concerns of empirical plausibility and analytical tractability.

distributional consequences across individuals and therefore produces different effects in coalition politics.

The model distinguishes between two broad types of government spending: public-sector employment and social benefits.[47] Once again, the model departs from accounting-based classifications in order to capture the distributional implications of different policies. Public-sector spending includes wages, pensions, and social services targeted directly to the public sector. Social benefits include healthcare, unemployment, and social-support programs that are not exclusively targeted towards the public sector. As with taxes, preferences over spending measures are a function of the composition of income. Table 1 displays the specific hypotheses linking preferences of political parties with fiscal policies advocated. For example, where the working class is largely distinct from the public sector, the working class favors reduced public-sector spending and increased spending on social benefits. The public sector favors spending on public-sector employment; where the public sector constitutes a large portion of the middle class, the middle class also prefers high levels of spending on public-sector employment. Social benefits are favored to varying degrees by the middle class, the public sector, and the working class.[48]

Party/Position on various measures	**Favored tax increases**	**Opposed tax increases**	**Favored spending cuts**	**Opposed spending cuts**
Corporate	Consumption, income	Property, social-security	Public sector, social benefits	NONE
Middle class	Consumption, corporate	Income, Social-security	Public sector, social benefits	NONE
Public sector	Corporate, Social-security	Income, consumption	NONE	Public sector, social benefits

[47] An important extension involves bank-related spending, the importance of which varied across the sample. In Ireland and Spain, governments and external actors contributed significant financial resources to rescue banks. In other cases, including Portugal and the first Greek bailout, bank-related spending featured less prominently.
[48] Important variation in preferences over fiscal policy exists within these income groups. Mares (2003) shows the importance of inter-group coalitions when, for example, government intervention offers the opportunity to shift costs away from the private sector. Once again, however, the model ignores such heterogeneity over concerns of analytical tractability. For more on inter-group coalitions, see Mares, Isabela. *The politics of social risk: Business and welfare state development*. Cambridge University Press, 2003.

Working class	Corporate, Social-security	Income, consumption	Public sector	Social benefits

Table 1. Policy preferences (columns) by party (rows). The first column lists the four primary constituencies considered in the present study: corporate, middle class, public sector, and working class. The second and third columns indicate opposing positions on tax increases; the fourth and fifth columns indicate opposing positions on spending cuts. Within each cell are particular policy measures.

Both the parties and the policies documented in Table 1 represent ideal types. Empirically, overlap in parties is observed, particularly in the middle two categories: the middle class and public sector. Where the public sector accrues sufficient resources to enter the middle class, the public sector assumes the middle-class, ideal-type preferences, with the important exception of continued opposition to public-sector cuts. In a given election cycle, the hybrid model treats occupational characteristics and party membership as given. This does not hold in the long run, as individuals move between income strata with shifts in occupation. Various parties gained and lost critical masses of supporters in the aftermath of the 2008 crisis. Examples of parties that gained dramatic vote shares include Syriza in Greece; Five Star Movement in Italy; and Ciudadanos and Podemos in Spain. In each of these countries, emergent parties took vote share from mainstream parties on both the left and the right.

The policies presented are also ideal types. While an improvement upon highly aggregated measures of fiscal policy,[49] the typology elides tremendous within-category variation. In a given electoral cycle, parties design policy that deviates from the ideal-type, tax-and-spend measures listed in Table 1. For example, in coalition with the public sector, a middle-class party may design income-tax increases that differentially target either the wealthy or the poor. Such nuanced strategies are most apparent in the cases of income taxes and social spending, in which

[49] Most studies of austerity politics employ measures such as government spending as a percentage of GDP. For representative examples, see the following: De Grauwe, Paul, and Yuemei Ji. "Panic-driven austerity in the Eurozone and its implications." VOX, CEPR's Policy Portal, 21 February 2013. Web. http://www.voxeu.org/article/panic-driven-austerity-eurozone-and-its-implications & Krugman, Paul. (2013). "Paul De Grauwe and the Rehn of terror." The New York Times Opinion Pages, Available: <http://krugman.blogs.nytimes.com/2013/02/22/paul-de-grauwe-and-the-rehn-of-terror/>.

seemingly insignificant shifts in tax brackets and targeted populations produce stark distributional consequences. As these examples suggest, parties do not deal in ideal types; rather they tailor policy to account for voter preferences and distributional consequences. However, an important part of modeling requires restricting the variation to be explained; while there is a large amount of variation in fiscal policies left unexplained by the hybrid model, the hybrid model explains an important and substantial portion of existing variation.

Connecting coalitions and preferred policies: Political capacity and external actors

Table 1 depicts preferences over adjustment policy. These preferences, in part, drive fiscal-policy outcomes. Preferences, however, are not translated directly into policy. Political entrepreneurs face a number of constraints when they attempt to translate party preferences into policy. Figure 1's schematic presents two of these constraints. The first is political capacity—operationalized in subsequent chapters as consonance within the governing coalition—and operates at all times. The second constraint involves external actors, which exert varying degrees of pressure on domestic constituencies. Subsequent sections discuss each in turn.

Hypotheses over political capacity

Setting aside the preferences of political parties, the capacity of governments to implement policy reforms varies across space and time. The ability to implement reform, regardless of ideological preference, is referred to as political capacity. While a number of dimensions characterize political capacity, the hybrid model emphasizes the preference homogeneity of governing parties, i.e., consonance. Consonance refers to the relative level of programmatic agreement between governing parties. Primary-cleavage consonance (PCC) governments have parties that agree on primary-cleavage policy. Primary-cleavage dissonance (PCD) governments have parties that disagree on primary-cleavage policy. Table 2 shows the breakdown of PCC's and PCD's over the sample. The left and right columns list consonant and dissonant governments, respectively.

PCC governments	**PCD governments**
Greece's alternating single-party governments between 2003 and 2011; Portugal's socialist governments between 2005 and 2011; Spain over the entire period;	Greece's grand coalition in 2013; Ireland FF-GR-PD coalition between 2007 and 2011; Italy's grand coalition starting in 2013;

Table 2. Levels of consonance for selected crisis governments. The columns indicate primary-cleavage consonance and primary-cleavage dissonance between governing parties.

Single-party governments are, by definition, PCC. An example of a PCC coalition is Portugal's coalition government of the Social Democratic Party (PSD) and Social Democratic Center-Popular Party (CDS-PP) elected in June 2011. PSD is a center-right party with a mass constituency; CDS-PP is a right party with a business constituency. In PCD's the coalition partners disagree on primary-cleavage policy. An example of a PCD is the coalition government of Fine Gail (FG) and Labour in Ireland elected in February 2011. FG is a center-right party; Labour is a center-left party. Uniting parties on the left and right, grand coalitions are almost always PCD's. This was the case following Greece's 2012 elections, with a grand coalition of PASOK-New Democracy-Democratic Left.

Hypothesis: Adjustment is increasing in political capacity. This stems from two related effects. High-consonance governments secure adjustment along lines beneficial to their respective constituencies. Low-consonance governments, which are typically riven by internal differences, implement limited reforms. Thus, in the aggregate, high-consonance governments implement deeper reforms than low-consonance governments.

Chapter 7's case studies seek to disentangle the effects of external actors from the effects of the decreased consonance that accompanies grand coalitions. The relevant endogeneity poses a particular problem for identifying the effects of political capacity on fiscal-policy outcomes. Consider the case of Italy: the pressure applied by external actors drove voters away from the two mainstream parties, the center-left Democrats (PD) and the center-right People of Liberty (PDL), and into Beppe Grillo's anti-establishment, Eurosceptic Five Star Movement. To secure a majority in parliament following the February 2013 general election, the PD and PDL entered government as a grand coalition and limited fiscal-policy reform, amid paralysis induced by disagreement within the governing coalition. In that case, however, it was the pressure from external actors and bond markets that produced a grand coalition. Absent such pressure, and without the necessary acquiescence of financial markets, Grillo's Five Star Movement would like have participated in Italy's government. Thus, it is only in a proximate sense that low consonance drove Italy's fiscal-policy response; but, ultimately, that consonance reflected the external financial context. Such endogeneity poses a particularly significant problem for Chapter 3's large-N analysis; Chapter 7's qualitative approach reduce the risk of spurious influence by parsing the relative effects.

Hypotheses over external actors

In order to fund policy initiatives and distribute rents to particular constituencies, governments require financial resources. These resources come from three principle sources: tax base, capital-market borrowing, and external actors. In good economic times, almost all funds come from the former two; states running current-account deficits draw a relatively larger proportion of their income from capital markets compared with states running either surpluses or balanced current accounts. These two sources of funds tend to produce fewer constraints compared with funds provided by external actors. However, revenue from taxation and capital-market funding are neither unlimited nor costless, particularly in turbulent economic times. On the one hand, the tax base is constrained both by time horizon as well as the size of the domestic economy. On the other hand, capital-market borrowing is constrained by prevailing interest rates.

When these rates exceed a country's debt-servicing capacity, a threshold frequently passed in turbulent economic periods, the country is locked out of debt markets. In such circumstances, states may resort to external actors for the necessary funds. Insofar as external actors have preferences over policy that diverge from domestic policymakers, these actors introduce an additional constraint on domestic coalition bargaining.

The hybrid model implies that bond yields influence fiscal-policy outcomes. However, bond-yield changes may be endogenous to domestic policy decisions. Policy decisions may drive changes in bond yields, which in turn drive a country to external actors. This is quite different from countries implementing reforms in response to the demands of external actors. Such endogeneity is what makes contagion particularly useful from an analytical perspective. This phenomenon, explored in Chapter 4, shows that, in many cases, the bond-yield co-movements of a given a country are exogenous to the policy decisions taken in that country. Instead, the yield movement reflects changes in another country. An example of such movement involves the Troika's negotiations with Greece throughout 2011 and 2012 that drove spreads in other peripheral Eurozone economies. Where possible, the analysis distinguishes between bond-yield movements that stem from domestic (endogenous) policy decisions and international (exogenous) circumstances.

Hypothesis (over demand conditions): Aggregate adjustment is increasing with bond-yield pressure, as domestic policymakers implement conditional reforms in exchange for funds and/or liquidity.

Particularly in the first two years of the crisis, the Troika had well-defined preferences over adjustment policy. The Troika favored spending cuts over tax increases. Even with a unified Troika in the first two years, the Troika faced internal resistance to its announced policies. As with respect to domestic actors, the preferences of external actors are not directly translated into policy. The policy influence of external actors is conditioned by the number of external actors, the homogeneity of their preferences, and their prior position in the crisis area. The first two variables affect domestic policymaking through the standard collective action logic. As Olson's logic (1965) suggests, ease of cooperation among actors decreases in the number of actors and the diversity of preferences among these actors.[50] Such difficulty may manifest through domestic policymakers' playing one set of actors off of another (strategic conflicts) or through pre-existing conflicts of interests that impede cooperation regardless of the actions of domestic policymakers (structural conflicts). Chapter 5 explores how the emergent preference heterogeneity within the Troika beginning in the second year of the first Greek bailout. The IMF, with its emphasis on debt sustainability, argued that Greece's debt load was unsustainable and had to be restructured. Within the context of the IMF's charter, such sustainability is particularly important, since the IMF cannot lend to insolvent countries. The ECB, with primary responsibility for Eurozone liquidity and the near-term real economic effects of liquidity risk, argued against debt reductions, based on their hypothesized implications on Eurozone banks. The deal that emerged between the ECB and the IMF was a compromise between the two positions, with debt restructuring limited to the private-sector holdings of Greek debt.

The final variable, extent of prior position in the crisis area, involves the pre-existing financial stake of the external actors in a particular area. The willingness of external actors to impose harsh terms on a country is decreasing in the extent of prior position. Returning to the second Greek bailout, prior positions produced important implications for the willingness of Troika policymakers to impose restructuring on private-sector holdings of Greek debt. Cypriot

[50] Olson, Mancur. *The logic of collective action*. Harvard University Press, 1965.

banks and companies held significant portions of Greek debt. Indeed, in relative terms, Cypriot banks were far more exposed to Greek bonds than were the banking systems of another major Eurozone economy. Notwithstanding the detrimental implications for the Cypriot position, Because of the limited exposure of French and German banks, the Troika was willing to impose losses on the private-sector holders of Greek debt. Where either external actors or dominant constituencies within these actors do not hold extensive positions in a target country, the external actor will be more willing to impose bankruptcy, as the value of the actors' assets will be relatively un-affected.

Hypothesis (over supply conditions): Aggregate adjustment decreases in the number of external actors, the heterogeneity of their interests, and the extent of their prior position in the domestic economy.

The discussion surrounding political capacity and external actors provides important insights into the role of domestic partisanship on fiscal policies adopted in response to financial crises. It is only in a special set of circumstances that parties translate the preferences from Table 1 directly into policy. In particular, two conditions must be satisfied for governing parties to translate preferences into policy: first, the governing coalition must be PCC; second, the influence of external actors must be mitigated, either as a function of supply or demand dynamics. These conditions provide a baseline from which to expect Table 1's preferences to be directly implemented in fiscal-policy outcomes.

Hypothesis: Policy preferences are most clearly translated into policy under conditions of programmatic consonance and marginalized external actors. Deviation from each of these characteristics dilutes the translation of Table 1 policy preferences into policy outcomes.

Outline of book

The remainder of the book is divided into seven chapters. Chapter 2 presents the data employed to measure the study's various independent and dependent variables. In addition, the chapter introduces the empirical strategy used to characterize each set of relationships implied by Figure 1. Depending on the available sources, the characteristics of relevant variables, and the precedent set in prior literature, the study employs a combination of large-N regression methods, intermediate-N quantitative approaches, event studies (with respect to the actions of external actors), and case studies (with respect to individual countries and governments). Chapter 3 presents a combination of less formal quantitative approaches and fixed-effects regressions. Chapters 4 & 5 address different dimensions of external-actor pressure on Eurozone countries. Chapter 4 employs factor analysis to explore contagion dynamics and bond-yield variation over the sample period. The chapter corrects important portions of conventional wisdom, particularly that related to the correlation of bond-yield movements within the so-called "PIIGS"—referred to here as a crisis countries—and between crisis and non-crisis countries. Chapter 5 employs an event-study approach to evaluate the effectiveness of external actors in shaping Eurozone member-countries' fiscal policies. The chapter considers only a subset of the universe of actions taken by external actors. These include bailouts, shifts in the nominal interest rate, large-scale refinancing operations, and EU-wide legislation related to fiscal policy. In Chapters 6 & 7, the emphasis shifts away from the pressure exerted by external actors and towards the study's remaining independent variables: partisanship and political capacity. Chapter 6 juxtaposes case studies of Spain and Portugal to explore how changes in the partisan hue of governing coalitions drives changes in fiscal policy. The chapter primarily relies on within-country analysis but concludes with a comparison of partisan politics between the two countries. As in Chapter 3, where unobserved heterogeneity between countries poses a concern for inferences based on between-country analysis, the conclusions drawn from Chapter 6's cross-country comparison should be treated as tentative. Chapter 7 juxtaposes analyses of Greece and Italy to explore how changes in consonance, one measure of political capacity, drive changes in fiscal policy. As in Chapter 6, Chapter 7 relies primarily on within-country analysis, comparing the fiscal policy negotiations and outputs between governments within individual countries. Both Chapter 6 & 7 discuss the case studies in the context of Chapter 3's statistical analyses. In particular, the weak statistical findings in Chapter 3, related to the role of consonance in fiscal-policy, receives extended attention in Chapter 7. The eighth and final chapter concludes with a reflection on how the various results presented in Chapters 3 through 7 validate and refine the hybrid model presented in Chapter 1. Importantly, Chapter 8 situates the findings of past chapters into ongoing debates within the literature. In addition, the concluding chapter discusses a number of possible extensions of the present research agenda, with an eye towards both future financial crises as well as countries and regions likely to face strong pressure in the medium- and long-term.

Chapter 2: Data, methods & empirical strategy

Introduction

Chapter 2 introduces the data, methods, and empirical strategy employed in the subsequent chapters. The chapter divided into three sections. The first section is a methodologically-motivated literature review, which discusses the literature's prior approaches to studying adjustment policy and how these studies characterized and identified the effects of economic and political variables. The second section discusses, in turn, the three independent variables that form the core of the hybrid model: political capacity, partisanship, and external actors. The third section discusses the study's dependent variable, fiscal policy.

Literature review

The study's empirical strategy relies on cross-country comparisons and within-country analysis, both quantitative and qualitative, of policymaking during and following the 2008 financial crisis. Methodologically, the present approach draws on the early contributions of Garrett (1998)[1], Hall & Soskice (2001)[2], and Simmons (1997)[3], along with the more recent contributions of Häusermann (2010)[4] and Woll (2014).[5] Simmons employs a combination of case studies and regressions by country-year to explore the factors influencing departure from the gold standard, an early example of adjustment policy. While the bulk of her study relies on cross-country regressions that span the decade following the Great Depression, Simmons

[1] Garrett, Geoffrey. *Partisan politics in the global economy*. Cambridge University Press, 1998.
[2] Hall, Peter A., and David Soskice, eds. *Varieties of capitalism: The institutional foundations of comparative advantage*. Oxford University Press, 2001.
[3] Simmons, Beth A. *Who adjusts?: Domestic sources of foreign economic policy during the interwar years*. Princeton University Press, 1997.
[4] Häusermann, Silja. *The politics of welfare state reform in continental Europe: Modernization in hard times*. Cambridge University Press, 2010.
[5] Woll, Cornelia. *The Power of Inaction: Bank Bailouts in Comparison*. Cornell University Press, 2014.

includes a separate chapter on France's particularly unstable period between 1924 and 1927. Over this period, several coalition governments presided, each with varying implications for adjustment policy. In the present work, Chapters 3 through 7 adopt the dual, regression and case-study approach, of Simmons and Garrett. The closest direct analog in the present case to the departure from the Gold Standard is exit from the Euro. Unlike in the interwar period, in which countries departed from the Gold Standard, there has been fairly limited reasonable political discourse (the sole exception involves some discussion prior to and following the second Greek bailout) surrounding exit from the prevailing exchange rate system, the Euro.[6] While Simmons restricts her substantive scope to departure from the gold standard, the present study considers a different dimension of adjustment policy: fiscal policy. In the most recent financial crisis, the key decisions facing Western European governments involved, *inter alia*, how to adjust fiscal policies to avoid sovereign default. The present study emphasizes Eurozone countries because of relative similarity of the broader policy space for adjustment; for these countries, external devaluation is not an option. In addition, the form of political intermediation—parliamentary politics characterized by relatively strong parties—is broadly similar across the sample.

Woll compares bank bailouts across a handful of European countries. Woll's particular substantive interest involves the relationship between financial-industry organization and banking-policy responses to the financial crisis. The present study follows Woll along two primary dimensions: the first relates to the operationalization of the dependent variable; the

[6] There has been serious discussion of Greece's exiting the Eurozone in the negotiations over the third bailout. These discussions fall outside the sample of this study which runs between 2000 and 2013 of the present study. The debate highlights that even exogenous factors, such as continued membership in the Eurozone, taken for granted in both academic and journalistic debate, are endogenous to the political process. Remaining in the Eurozone is a political choice that is periodically, if not continuously, reaffirmed by domestic politicians. For the purposes of the present study, it is enough that the Eurozone be viewed by politicians as costly to exit. This almost certainly seems to be the case, as all except the most extreme political parties in Eurozone's member-countries advocate remaining in the Eurozone. This is not to say, however, that mainstream politicians always agree with policy consequences of remaining in the Eurozone.

second relates to the form of controlled comparisons adopted in Chapters 6 & 7. With respect to the dependent variable, Woll develops a framework to allow cross-country comparison by classifying domestic responses to financial crises into four broad categories: recapitalization, banking guarantees, asset relief, and other liquidity provision. Woll admits that her categorization is neither exhaustive nor mutually exclusive. She argues that it does, however, capture a large portion of systematically important variation within a relatively tractable analytical framework. Chapter 3 through 7 adopt an analogous approach to fiscal policy, dividing it into two broad categories: taxation and spending. These are further disaggregated into four (consumption, income, social-security, and corporate) and two (social benefits and public sector) subcategories, respectively. This approach is a marked difference from past studies of austerity. At their most aggregated, these studies consider the deficit as a proportion of GDP. A second, slightly more nuanced approach, considers the two primary subcomponents of the deficit: taxation and spending. Importantly, some the differing conceptualizations reflect a genuine interest in a fundamentally different dependent variable and a different set of research questions. However, when applied to questions of political processes, the prevalent measures of austerity are demonstrably inadequate, given the diverse distributional implications of underlying policies. It is important to note that, as with Woll's approach, the disaggregated measure of fiscal policy adopted here does not capture all possible empirical variation in the dependent variable; the approach taken here, however, captures a non-trivial portion of important variation within the context a relatively tractable analytical framework.

The present dissertation also adopts Woll's style of controlled comparisons. Chapters 6 & 7 identify countries and political situations that differ along relevant independent variables and assess how these differences contribute to observed variation in fiscal-policy outcomes. Chapter

6 evaluates the role of partisanship by comparing governments in Portugal and Spain. Chapter 7 evaluates the role of political capacity by comparing the performance of governments in Greece and Italy. In contrast to Woll's approach, Chapters 6 & 7 explore variation within the individual countries over time to provide additional leverage with which to evaluate the model's proposed explanatory factors. Crucially, this set-up does allows neither Woll's nor the present study to control for all independent variables. With respect to the hybrid model presented in Chapter 1, there are a number of variables excluded for the pragmatic reasons of analytical tractability and difficulty of measurement. The concerns about endogeneity, noted in Chapter 1's discussion of the independent variables, introduce a subset of these concerns. Two additional potential omitted variables deserve mention, particularly given their importance to past approaches in the literature. First, the model ignores private-sector bond holders as a separate actor.[7] Although, in principle, these might be included as a variety of external actor, they are largely ignored in the present context because of the dominant role played by national governments in the sovereign-debt crisis. In the few situations where they feature prominently, private-sector bondholders are effectively coerced by supranational institutions, as in the private-sector involvement in the second Greek bailout. Second, an expanded model might include a richer organizational complexity, including trade unions and employer organizations. These are stressed in Hausermann's accounts of pension reform in Europe and are featured as a defining characteristic of CME's in the typology of Hall & Soskice. They are excluded in the hybrid model in favor of an expanded model of party competition and cooperation.

[7] Private-sector bondholders feature prominently in Aggarwal's account of negotiations between developing economies negotiating to reduce their debt burden. The full citation is as follows: Aggarwal, Vinod K. *Debt games: Strategic interaction in international debt rescheduling*. Cambridge: Cambridge University Press, 1996.

Notwithstanding potentially omitted variables and related concerns with endogeneity, the present work adopts a framework of controlled comparisons, because large-scale, socioeconomic phenomenon are nearly impossible to study in an experimental framework. Adopting an experimental approach would enslave the study to a narrow lens of identification that would likely only apply, albeit precisely, to a small portion of the fiscal policy space. In the larger trade-off between substantive importance and identification, the present approach emphasizes substantive importance while bearing in mind the potential pitfalls of a framework that lacks perfect causal identification. One way, already mentioned, that the present study deals with the identification problem and departs from Woll's framework is by considering individual countries and shifting coalitions over time.

In explaining fiscal-policy responses, the present dissertation emphasizes political parties and coalitions. The political logic and mechanisms draw on Hausermann's exploration of continental welfare-state reform. In particular, Häusermann (2010) explores the importance of political parties, unions, and employer organizations to explain pension reform. The present study adopts Häusermann's approach to coding the positions of political parties. Using party statements and documents, Häusermann attempts to identify party preferences. Acknowledging that strategic incentives may prevent parties from revealing their true preferences, Häusermann measures preferences well prior to the reform. Such temporal distance ameliorates, but does not eliminate, concerns over strategic revelation. The present case studies follow Häusermann in the coding of party preferences prior to bargaining periods. In particular, the present approach relies on the Comparative Manifesto Project as a source of party preferences.[8]

[8] Volkens, Andrea, Lehmann, Pola, Merz, Nicolas, Regel, Sven, Werner, Annika with Lacewell Onawa Promise, Schultze, Henrike (2014): The Manifesto Data Collection. Manifesto Project (MRG / CMP / MARPOR). Version 2014b. Berlin: Wissenschaftszentrum Berlin für Sozialforschung (WZB).

Independent variables

Partisanship

Empirical strategy

The type of coalition in government produces important implications for fiscal policies. Subsequent chapters employ two broad approaches to conduct within-country analysis. The dissertation largely employs within- rather than between-country analyses, because differing political contexts between countries increases the risk of unmodelled heterogeneity. For example, consider the conservative parties of Italy and Spain. Italy's People of Liberty is a diverse coalition of populist, xenophobic, Eurosceptic, and business interests. Spain's Popular Party is relatively homogeneous and pro-business. While both are to the right of the respective left parties in each country (the Democratic Party in Italy and the PSOE in Spain), it is not clear in a regression context whether a "1 percent move to the right" is comparable in the two countries. The present dissertation conducts within-country analysis with two primary methods, one quantitative, and the other qualitative. First, Chapter 3 employs fixed-effects regression. Second, Chapter 6 introduces a set of case studies that evaluate the role partisanship over time within individual countries. In particular, Chapter 6 compares governments of different hues within Portugal and Spain. In addition to the within-country approach, there is limited between-country analysis. The latter analysis should not be taken as the main empirical test of Chapter 1's hybrid model. The broad comparison, however, is illustrative and helpful to understanding the conditional role of financial-market pressure driving partisan autonomy.

Measure

There are a number of ways to measure the preferences of political parties. The present dissertation relies on and derives measures from the Comparative Manifesto Project (CMP).[9] The CMP codes party manifestoes released prior to elections. The manifestoes are broken down into a series of statements, called “quasi-sentences.” Each quasi-sentence is then coded as belonging to a certain category, e.g., “Free Market Economy,” “Market Regulation,” “Keynesian Demand Management,” etc. When aggregated, the codings of quasi-sentences, generate a number indicating the proportion of a given manifesto dedicated to each topic. This proportion is then used as indicator of the topic’s importance for a given party.

Because their derivation is less than intuitive, this section presents an example derivation and then walks through an example showing how subsequent chapters employ the derivations. CMP’s RILE measure is the traditional indicator used to measure the RIght-LEft positions of political parties. As Table 1 indicates, RILE includes several policy dimensions beyond either fiscal policy in particular or economic policy in general. Historically, these dimensions have been highly correlated. However, with the opening up of the European party space with the arrival of the Greens and ecological movements in the 1970’s and the more recent processes of deindustrialization and increasing economic importance of services, these dimensions have become less correlated.[10] Table 1 includes the RILE measure as a point of reference; however, the dissertation relies more heavily on the MODRILE measure. Effectively, as can be seen in the bottom row of Table 1, MODRILE is constructed by extracting the economic policy dimension from the original RILE measure. Thus, for example, “Traditional Morality: Positive” is removed since it is not related, in any direct sense, to preferences of fiscal policy.

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[9] Volkens, Andrea, et al. 2014.

[10] See Kitschelt (1994) for the former and Hausermann (2010) for the latter. The complete citation for Kitschelt is as follows: Kitschelt, Herbert. *The transformation of European social democracy*. Cambridge University Press, 1994.

Name of measure	Derivation of measure
CMP’s RILE	(Military: Positive + Freedom and Human Rights + Constitutionalism: Positive + Political Authority + Free Market Economy + Incentives + Protectionism: Negative + Economic Orthodoxy + Welfare State Limitation + National Way of Life: Positive + Traditional Morality: Positive + Law and Order: Positive + Civic Mindedness: Positive) - (Anti-imperialism + Military: Negative + Peace + Internationalism: Positive + Market Regulation + Economic Planning + Protectionism: Positive + Controlled Economy + Nationalization + Welfare State Expansion + Education Expansion + Labour Groups: Positive + Democracy)
MODRILE	(Free Market Economy + Incentives + Protectionism: Negative + Economic Orthodoxy + Welfare State Limitation) - (Market Regulation + Economic Planning + Protectionism: Positive + Controlled Economy + Nationalization +Welfare State Expansion + Education Expansion + Labour Groups: Positive)

Table 1. Measures employed to estimate party positions. The left-hand column indicates the names used to identify particular measures. The right-hand column indicates the combination of indicators used to calculate a given measure. For details of individual indicators, see Volkens, et al. 2014.

Figure 1 provides an example that illustrates the presentation of the data in subsequent chapters. As a first take, Figure 1’s left-hand-side panel presents the CMP’s RILE measure. Each party is positioned at a different point along the horizontal axis and is labelled according to a standard abbreviation. In the Irish case, the Green and Labour parties are both labelled with their full names. Sinn Fein, Fianna Fail, Fine Gael, and the Progressive Democrats are indicated with SF, FF, FG, and PD, respectively. Along the vertical axes for the RILE and MODRILE graphs, the left-most positions are negative and the right-most positions are the most positive. In 2007, according to the RILE measure, the PD was Ireland’s right-most party and the Greens Ireland’s left-most.

MODRILE, the economic dimension extracted from the CMP’s RILE measure, is presented in an analogous. Differences between RILE and MODRILE stem from the shift in left-right positions, when non-economic dimensions are excluded from the policy space. In the MODRILE space, SF is the farthest left, and Green and Labour are more centrist relative to their

RILE positions. This indicates that SF's divergence from the other parties is primarily along an economic dimension. Moreover, the MODRILE space reveals that the Green and Labour parties are relatively conservative along economic dimensions, an observation occluded in the more crowded RILE space. In addition, in a pattern observed in other crisis countries, MODRILE indicates a compression of the ideological space. Table 2 shows the summary statistics for the study's explanatory variables. MODRILE ranges from 0 to 1, with a mean of 0.49. Table 2's MODRILE score is standardized for each country-election. This is achieved by dividing all parties' MODRILE scores in a given election by the party's score with the highest absolute value.

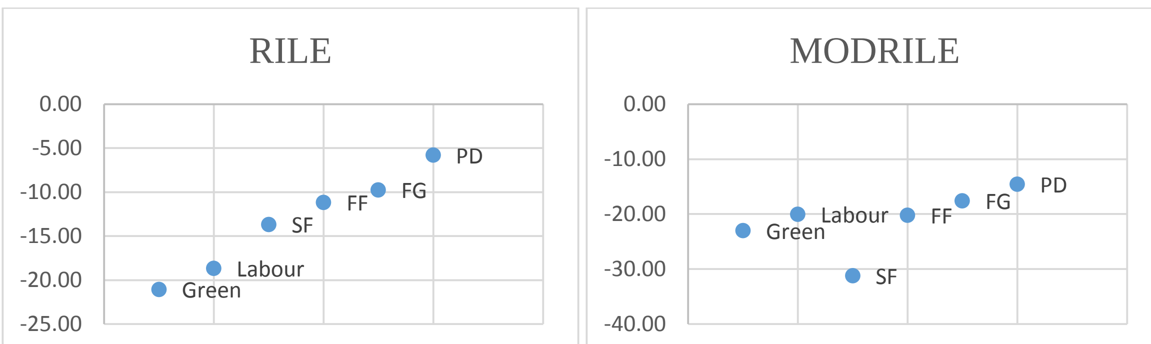


Figure 1. The policy positions of Irish political parties in 2007 derived from the CMP measures. The left panel shows the CMP's RILE measure. The right shows MODRILE, which extracts RILE's economic component. In each graph, the Green and Labour parties are labelled with their full names. Sinn Fein, Fianna Fail, Fine Gael, and the Progressive Democrats are indicated with SF, FF, FG, and PD, respectively.

	Mean	Median	Minimum	Maximum
MODRILE	0.49	0.5	0	1
Consonance	0.695	0.8	0.2	1
Bond-yields	4.463	4.111	1.552	24.723

Table 2. Summary statistics of the study's independent variables. The first column indicates the relevant independent variable. The succeeding columns indicate various summary statistics: mean, median, minimum, and maximum.

Consonance

Empirical strategy

Programmatic consonance varies both within and between countries. The empirical strategy exploits both sources of variation. As with respect to partisanship, the dissertation explores within-country variation in consonance with both regression and case studies. Unlike with respect to partisanship, however, the limited variation in consonance limits the usefulness of fixed-effects regressions. Thus, the analysis of consonance, relies to a larger extent than the analysis of partisanship, on case studies. Chapter 7 compares government variation over time in Greece and Italy. In addition, as in the case of partisanship, the case-study methodology enables limited between-country comparison.

Measure

Consonance is measured with Equation 1:

$$\boldsymbol{C = 1 - (Rank_{High} - Rank_{Low})/Max(Rank)} \qquad (\textit{Equation 1})$$

C is the programmatic consonance of a given government. To calculate the rank of a given party, the parties in a government are ordered and assigned integer ranks according to their MODRILE. The rank of the party with the lowest MODRILE score in a governing coalition is then subtracted from the rank of the party with the highest MODRILE score in the governing coalition.[11] This difference is then divided by the number of parties competing in a given election, which is equivalent to the maximum rank.[12] This result in then subtracted from 1. In this way, consonance is increasing in ***C***, with 1 being the highest possible score. The equation generates a range of [1,0).

This equation indicates two important features of the consonance measure. First, single-party governments, for which, by definition, Rank_{High}=Rank_{Low}, generate consonance scores of 1. Second, the lower limit for consonance depends on the number of parties contesting an election. The lower limit for an election with *n* parties is [1-(*n*-1)/*n*]. This expression reduces to 1/*n*.

[11] This difference is the core theoretical expression in the equation. The remaining terms work as scaling coefficients.
[12] Scaling by the maximum rank prevents countries with fewer political parties in a given election from having artificially higher levels of consonance.

Where there are two parties, thus, both maximum and minimum consonance are 0.5; in the sample these conditions only apply in Malta's 2008 elections. Table 2 shows that consonance in the sample, which covers Eurozone economies between 2000 and 2013, ranges from a low of 0.2 to a high of 1. The median of 0.8 shows that the data is skewed towards 1. Indeed, 47 of the 151 observations of the sample are 1, indicating the high proportion of single-party governments (the vast majority of which were majority, rather than minority, governments) across the sample. This is important to bear in mind, particularly against the backdrop of the caricature of continental multiparty systems giving rise to governments paralyzed by disagreements within unwieldy coalitions.

External actors

Empirical strategy

External actors play a potentially large role in the adjustment policy adopted by individual countries. As with partisanship and consonance, the present study employs both a large-N regression approach and a qualitative approach to explore the effects of external actors within the hybrid model. With respect to the former, Chapter 3's fixed-effects regressions use bond yields as a proxy for external-actor influence. Because of the outsized role occupied by bond yields in journalistic accounts of the financial crisis and the responses of individual countries, Chapter 4 employs factor analysis and explores the dynamics of bond yields over the crisis sample. With respect to qualitative approaches, Chapter 5 presents event analyses and a series of case studies that focus on subset of events. Chapter 5 places particular stress on the channels by which pressure from external actors is translated into domestic policy outcomes.

Measure

In the context of external actors, it is important to define the universe of potential external actors. The present study defines an external actor as an institution or country that can offer significant financial aid to a crisis country. The crisis country may have influence in the external actor (as do the crisis countries with the Troika through the European Commission and International Monetary Fund), but they cannot dominate, either politically or economically, the external actor.[13] Potential external actors include, but are not limited to, the Troika, the World Bank, regional organizations such as NATO, and non-crisis countries that possess significant financial resources. The Troika, in particular, may be treated either as a single organization or as three different organizations: the EC, the IMF, and the ECB. Since the Troika attempts to present a single voice in policy discussions, the present study treats it as a single external actor. That said, important divisions emerged within the Troika over the life of the crisis. Chapter 5 explores the policymaking implications of these divisions.

Event	**Date**	**Target country, institution, or area**	**Homogeneity of Troika**	**Number of external actors**	**Prior position**
Nominal interest rate	09/2008	Eurozone	Homogeneous	Discount rate drops from 4 percent in 09/2008 to a floor of 1 percent in 05/2009	
Legislation	02/2009	EU	Homogeneous	Establishes the European Economic Recovery Plan, a series of Keynesian measures to increase demand and spur economic growth within the EU.[14]	
Bailout	05/2010	Greece	Homogenous	1	Limited
Bailout	11/2010	Ireland	Homogenous	1	Limited
Legislation	02/2011	EU	Homogenous	Implements a series of measures to correct deficits that exceed those	

[13] Thus, the EC/ECB are external actors with respect to all Eurozone countries, with the possible exception of Germany, which, to some extent, can dominate the ECB. There are, however, limits to Germany's power within the ECB. These limits were shown in Mario Draghi's implementation of OMT in September 2012, in which, over the explicit dissent of Bundesbank Governor Jens Weidmann, the ECB announced the large-scale purchase of sovereign debt from the Eurozone's periphery. See the following article for a discussion of the debate within the ECB's governing council: Steen, Michael. "Weidmann isolated as ECB plan approved." *Financial Times*. 7 September 2012.

[14] "A European Economic Recovery Plan." *EUR-Lex*, 26 November 2008. Web. < http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1439818628650&uri=URISERV:ec0004>.

				permitted under the Excessive Deficit Procedure.[15]	
Nominal interest rate	04/2011	Eurozone	Homogenous	Discount rate increases from 1 percent in 04/2011 to a ceiling of 1.5 through 10/2011	
Bailout	05/2011	Portugal	Homogenous	1	Limited
Nominal interest rate	10/2011	Eurozone	Homogenous	Discount rate drops from 1.5 percent in 10/2011 to a floor of 0.25 percent in 11/2013	
Bailout	12/2011	Cyprus	Homogenous	2	Russian deposits; Greek holdings of Cypriot debt
LTRO	12/2011	Banks in Greece, Ireland, Italy, and Spain	Heterogeneous	1	Sovereign debt from bailouts;
Legislation	12/2011	EU	Heterogeneous	“Six-pack” enters the force establishing limits on both government debt and deficit. Takes steps to improve EU surveillance of both.[16]	
LTRO	02/2012	Banks in Greece, Ireland, Italy, and Spain	Heterogeneous	1	Sovereign debt from bailouts; debt from prior LTRO
Bailout	02/2012	Greece	Heterogeneous	1	ECB’s holding of Greek debt
Legislation	03/2012	EU	Heterogeneous	Treaty on Stability, Coordination, and Governance—alias “Fiscal Compact”—expands the EU’s monitoring and advisory powers with respect to the budgets of member governments.[17]	
Bailout	06/2012	Spain	Heterogeneous	1	ECB’s holdings of Spanish sovereign bonds
OMT	09/2012	Eurozone banks	Heterogeneous	1	Sovereign debt from bailouts; debt from LTRO’s
Bailout	04/2013	Cyprus	Heterogeneous	2	Limited
Legislation	05/2013	EU	Heterogeneous	“Two-pack” enters into force, which formalizes the oversight	

[15] “The corrective arm: the excessive deficit procedure.” *EUR-Lex*, 2 February 2011. Web. <http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1439819458086&uri=URISERV:l25020>.
[16] “Surveillance of budgetary policies.” *EUR-Lex*, 1 June 2012. Web. <http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1439819458086&uri=URISERV:l25019>.
[17] “Treaty on stability, coordination and governance in the economic and monetary union.” *European Commission: Press Release Database*, 1 February 2012. Web. <http://europa.eu/rapid/press-release_DOC-12-2_en.htm>.

				process of Brussels with respect to member-country budgets.[18]

Table 3. Relevant events involving external actors. The type of event, whether a change in the nominal interest rate (for the time series, see Figure 1 of Chapter 5), a bailout, a LTRO, or legislation, is noted in the first column. The second column indicates the month and year of the event. The third column indicates the crisis country or institution (in the case of bank bailouts) targeted. The fourth column indicates the relative homogeneity of the Troika in a particular event. The fifth column indicates the number of relevant external actors. The sixth and final column indicates the prior position of relevant external actors.

There are a wide number of events that involve external actors that are potentially relevant to the fiscal policies adopted by crisis countries. The first column indicates a particular event. Table 3 lists four varieties of events: changes in the nominal interest rate, refinancing operations (both LTRO's and OMT's), bailouts, and EU-level legislation. First, central banks conduct conventional monetary policy by changing the nominal interest rate. With stick prices (either in the general price level or in wages), a change in the nominal rate passes through the real interest rate. Second, a large number of refinancing operations took place over the crisis period. However, under Mario Draghi's leadership, the ECB expanded lending aggressively, increasing the maturity (from six months to three years) and the amounts available for Eurozone banks. Over the sample period, the ECB instituted two rounds of long-term refinancing operations (LTRO's). In September 2012, in an attempt to increase the conditionality of purchases of sovereign debt under the Securities Market Programme (SMP), Eurozone policymakers replaced with the SMP with Outright Monetary Transactions (OMT), which incorporated a policy of strict conditionality.[19]

[18] "'Two-pack' enters into force, completing budgetary surveillance cycle and further improving economic governance for the Euro area." *European Commission: Press Release Database*, 27 May 2013. Web. <http://europa.eu/rapid/press-release_MEMO-13-457_en.htm>.

[19] The relative inflexibility caused by this move led some Eurozone policymakers to lament the dismantling of the SMP. This became an issue in late 2012, with increasing bond yields on Italian sovereign debt. Disbursement of OMT funds required that a target country have an open line of credit with either the EFSF/ESM, the EU's bailout facilities. As Italy had not received a bailout, it was ineligible to receive OMT funds. For a representative article in the press, see the following citation: Barber, Tony and Michael Steen. "'Whatever it takes': the Italian determined to save the Euro." *Financial Times*. 14 December 2012.

Third, bailouts refer to the transfer of funds from the Troika to target countries. Such transfers differ from LTRO’s, because they are extended to sovereign governments, rather than to Eurozone banks. Moreover, LTRO’s are orchestrated by the ECB, whereas bailouts are conducted by the EC, the ECB, and, frequently, the IMF. The first bailout in the sample occurred in Greece in May 2010. The last occurred in Cyprus in April 2013. The only bailout in the sample not involving Europe’s supranational institution occurred when Russia provided €2.5 billion to Cyprus in December 2011. Bailout codings are relatively uncontroversial, with the exception of Spain’s in June 2012. Spain’s center-right government bargained extensively with the Troika to avoid the extensive fiscal conditionality required by prior bailout recipients. Ultimately, the Troika eschewed much of the conditionality required in prior bailouts. The Troika, however, refused to accede to Spain’s request that banks be bailed out directly, rather than indirectly through the government. As a result, the bailout of Spain combined elements of past bailouts (lending by the EC/ECB to a sovereign government) and LTRO’s (limited conditionality).

The fourth and final type of event involves EU-level legislation that conditions the fiscal policy space of member countries. Such legislation is typically negotiated by the senior politicians present at each summer’s Eurozone summit. The first EU-level legislation involved an initial Keynesian response to the financial crisis. Using the European Investment Bank as the primary vehicle, the EC attempted to stimulate flagging demand in the face of strong financial-crisis headwinds. After a 2010 dominated by the ad hoc response of the EC and the ECB to the crises in Greece and Ireland, the Keynesian impulse was reversed in 2011 and 2012 with successive legislation designed to strengthen both the surveillance and enforcement of the Stability and Growth Pact. Typically, such legislation passed with limited offsetting expansionary policy, such as the ECB's rounds of LTRO. Although the ECB is nominally independent from the EC, the coincidence of such shifts strongly suggests the political logic of bundled tradeoffs as partially facilitating EU-level reform.

The second column in Table 3 indicates the month and year of particular events, ranging from the September 2008 changes in the nominal interest rate to the "Two-Pack" legislation adopted in May 2013. The third column indicates the targeted country, institution, or area, depending on the type of event. Bailouts target countries; refinancing operations target banks in particular countries; and legislation applies to the EU as a whole. Coding in each of these columns is relatively straightforward, with the exception of the refinancing operations. Because recipient banks did not want to be seen as weak, and the ECB did not want to cause capital flight from already fragile bank balance sheets, the recipient banks remained secret. Although some banks reported their positions, systematic data for recipient banks was not available.[20] Based on the limited reporting in the financial press, banks in Greece, Ireland, Italy, and Spain, in addition to a number of non-crisis countries received LTRO funds.

The fourth column indicates the homogeneity of the Troika at the time of a particular policy action. The Troika consists of three organizations: the EC, the IMF, and the ECB. In the beginning of the crisis period, these organizations worked together relatively seamlessly. In the latter part of the crisis period, the working relationship between organizations deteriorated. Coding of homogeneity is based on the financial press. Where the financial press mentions significant disagreements among Troika members, the event is labelled as heterogeneous; otherwise, the event is coded as homogeneous. Disagreement within the Troika occurred along a number of axes. First, there was tension between southern European and northern European

[20] "Which banks took up second round of LTRO." *Wall Street Journal*. 29 February 2012.

countries. This disagreement primarily manifested in tension between the EC, with representation skewed towards the southern economies, and the ECB, with representation skewed towards the northern economies. Second, over the crisis period, the IMF, with its constituency beyond the EU, grew to resent what it saw as coddling of Eurozone countries, relative to the past treatment of IMF-member countries in the East Asian currency crisis and Latin American debt crisis. The former cleavage emerged earlier in the crisis period; the latter became a salient point of contention late in the crisis period and proved particularly important in the bailout of Cyprus. Chapter 5 explores the implications of evolving preference heterogeneity on the fiscal policies adopted in crisis countries.

The fifth column, for bailouts and refinancing operations, indicates the number of external actors relevant to a particular event. Only one crisis country, Cyprus, engages with more than one external actor. Although it falls outside the scope of the present dissertation, Greece's overtures to Russia during the negotiations over the third Greek bailout provides another example of a second external actor. In addition, periodic reference was made of funds from China providing a potential solution to the Eurozone crisis.[21] In no case, however, were these funds discussed in either a sustained or consistent manner. The sixth and final column, for bailouts and refinancing operations, indicates the prior position of external actors relevant to a particular event. These are limited in the case of the early bailouts, when the ECB's balance sheet contained few sovereign bonds. In later bailouts and LTRO's, the ECB and Eurozone governments had acquired substantial positions in the debt of crisis countries. In the Russian case, Russian depositors held large positions in Cypriot retail banks. In the case of EU-level

[21] Here a handful of representative citations to the periodic references made to China as a potential savior to the Eurozone crisis: Barber, Tony. "Greek aid role for China and Russia?" *Financial Times*. 29 April 2010; "East of Athens; Greece is wise not to spurn Chinese investment interest." *Financial Times*. 17 June 2010; Barber, Tony. "Enter the technocrats." *Financial Times*. 12 November 2011.

legislation, the fifth and sixth columns include a brief description of the legislation adopted; with respect to changes in the nominal interest rate, the fifth and sixth columns provide the floor and ceiling of the implemented rate change

Susceptibility to external actors: Bond yields

Countries have three primary sources of funds: taxation; capital markets; and external actors. During a crisis period, when re-financing debt is crucial to preventing country reliance on external actors, countries have limited ability to collect taxes in order to cover the costs of refinancing. This reflects both the time horizon of revenue collection as well as the hypothesized adverse implications of increased taxation on economic growth. Thus, particularly during tranquil economic periods, countries rely on capital markets. Whether a country can draw on capital markets is function of the prevailing bond yield. Bond yields, thus, indirectly measure the pressure on sovereign governments to resort to external actors. When bond yields increase beyond the rate at which debt can be sustainably re-financed, governments turn towards external actors. The threshold bond yield depends on existing levels of debt and the macroeconomic forecast for a given country. While there is necessarily a level of subjective judgment involved in sustainability, domestic political discourse and the financial press indicates a clear relationship between bond yields and the pressure to seek funding from external actors. Chapter 3 explores the correlation structure of bond yields over the crisis sample. Such structure is particularly important given concerns over contagion in financial markets. Contagion has troubling implications for Europe's democratic deficit. In effect, if the contagion hypothesis is correct, events in a neighboring country drive yields domestically. To the degree that yields are connected to domestic policy, events in neighboring countries drive domestic policy and thus further exacerbate the EU's democratic deficit.

Disaggregating fiscal policy: The dependent variable

Adjustment policy consists of a wide array of policy measures. The present study focuses on fiscal-policy measures. It follows De Grauwe & Ji (2013) and disaggregates fiscal policy into taxation and spending.[22] However, subsequent chapters go beyond these authors and disaggregate taxation into four subcomponents and spending into three subcomponents. The study considers consumption, income, social-security, and corporate taxation; on the spending side, the study considers social benefits and public-sector compensation. Those data are collected from a variety of sources, including the OECD's iSTAT database and TradingEconomics proprietary data.

Dependent variable	**Mean**	**SD**	**Minimum**	**Maximum**
DEFICIT	-0.0286	0.0466	-0.3171	0.0591
EXPENDITURE	0.4579	0.0891	0.2534	0.9057
REVENUE	0.4292	0.0748	0.2834	0.6850
SOCIAL BENEFITS	0.1898	0.0448	0.0721	0.2912
COMPENSATION	0.1052	0.0241	0.0650	0.1899

Table 4. Summary statistics for aggregate fiscal environment and expenditure items. The first column indicates the relevant fiscal category; the second column indicates the mean; the third column indicates the standard deviation; finally, the fourth and fifth columns indicate the minimum and maximum, respectively.

		Mean	**SD**	**Minimum**	**Maximum**
INCOME	RATE	45.7975	7.6354	19.0000	60.6000
	REVENUE	8.1923	2.7235	2.2520	14.0310
CONSUMPTION	RATE	19.3937	2.1453	15.0000	24.0000
	REVENUE	11.1388	1.2714	6.8380	14.5960
SOCIAL SECURITY	RATE	36.7581	10.7746	12.8000	55.5300
	REVENUE	11.8094	2.9417	3.6560	16.7510
CORPORATE	RATE	29.3911	7.1281	12.5000	51.6000
	REVENUE	2.9122	1.1574	0.5820	7.7840

Table 5. Summary statistics for categories of revenue. The first column indicates the relevant fiscal category; the row indicates either a rate or revenue, with the latter measured as a percentage of GDP; the second column indicates whether the third column indicates the mean; the fourth column indicates the standard deviation; finally, the fifth and sixth columns indicate the minimum and maximum, respectively.

[22] De Grauwe, Paul, and Yuemei Ji. "Panic-driven austerity in the Eurozone and its implications." VOX, CEPR's Policy Portal, 21 February 2013. Web. <http://www. voxeu.org/article/panic-driven-austerity-eurozone-and-its-implications>.

Tables 4 & 5 present summary statistics for the subcomponents of fiscal policy examined in subsequent chapters. Over the sample, governments run average deficits of about 2.9% of GDP. This results from government expenditures worth 45.8% of GDP combined with revenue that amounts to 42.9% of GDP. Disaggregating the spending, governments spend an average of 19.0% of GDP on social benefits and 10.5% on public-sector compensation. For all of these statistics, there is wide variation across the sample, both within countries over time and between countries.

Two types of data shown in Table 5 are collected with respect to disaggregated components of taxation: rates and revenue. Tax rates refer to the politically determined tax charged on some activity (e.g., earning income, consuming goods). Revenues represent the macroeconomic aggregate of microeconomic decisions made by individuals that consider, *inter alia*, tax rates. Because they are determined directly through a political process, rates provide a more relevant test of the political hypotheses implied by the hybrid model. Revenues, which reflect a wider set of political and non-political considerations, are a less direct test of the explicitly political process described in Chapter 1. While the subsequent analysis discusses results in the context of both rates and revenues, changes in the former more closely reflect the political logic of the proposed theory.

Chapter 3: Large-N approaches to studying fiscal-policy responses to the financial crisis

Introduction

The present chapter is divided into two sections. The first section examines the time series and summary statistics of the aggregate adjustment data. This section is primarily descriptive and suggests trends underlying the data. The second section presents t-tests and fixed-effects regressions that test the political and economic hypotheses derived from the hybrid model.

The time series of adjustment paths

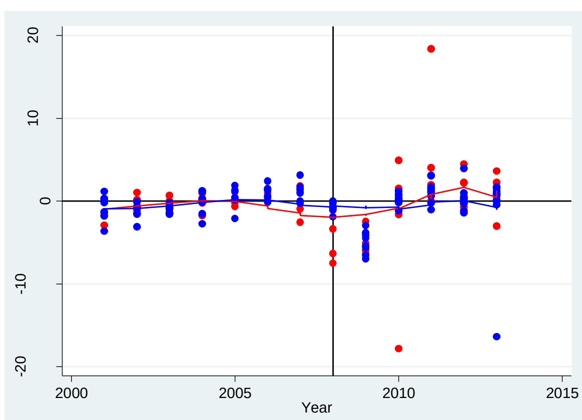
Aggregate fiscal variables

Table 1 presents the summary statistics first introduced in Chapter 2's discussion of data. Dollar figures, both revenues and expenditure, are expressed as a proportion of GDP. This facilitates comparison between countries but also complicates interpretation. Changes in fiscal variables relative to GDP may reflect either changes in the fiscal variables or GDP. Table 1 shows that the average deficit across Eurozone countries between 2000 and 2013 was about 2.9% of GDP. The average Eurozone government between 2000 and 2013 spent 45.8% of GDP and collected 42.9% of GDP in revenue from taxation. For each of these aggregate fiscal characteristics, there is substantial variation in both the cross-section and the time series, as indicated by the standard deviations, minima, and maxima. Figures 1 & 2 delve into the time-series variation of Table 1's summary statistics.

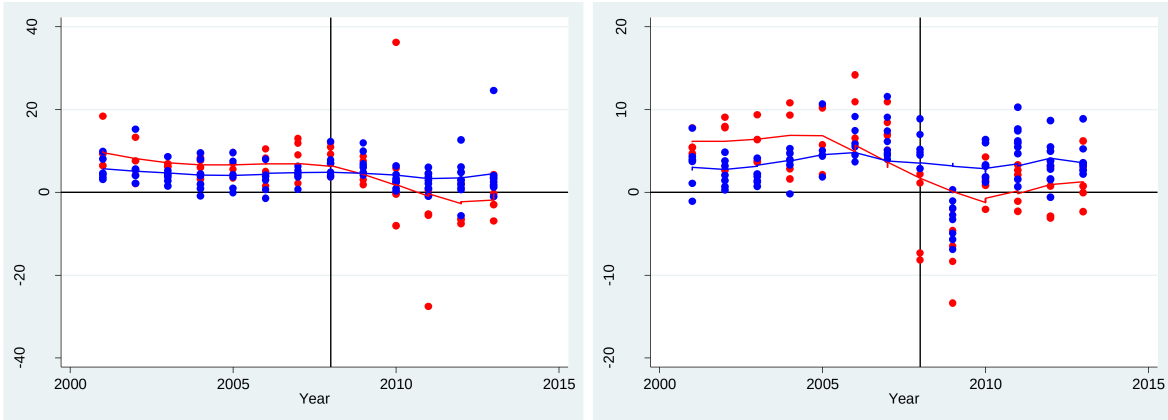
Dependent variable	Mean	SD	Minimum	Maximum
DEFICIT	-0.0286	0.0466	-0.3171	0.0591
EXPENDITURE	0.4579	0.0891	0.2534	0.9057
REVENUE	0.4292	0.0748	0.2834	0.6850
SOCIAL BENEFITS	0.1898	0.0448	0.0721	0.2912
COMPENSATION	0.1052	0.0241	0.0650	0.1899

Table 1. Summary statistics for aggregate fiscal environment and expenditure items. The first column indicates the relevant fiscal category; the second column indicates the mean; the third column indicates the standard deviation; finally, the fourth and fifth columns indicate the minimum and maximum, respectively.

Figure 1 presents the time series of the percent changes in deficit (upper panel), expenditure (lower-left panel), and revenue (lower-right panel). The vertical line in each panel indicates the year of Lehman Brother’s failure, 2008, which is used to mark the beginning of the financial crisis. The straight horizontal line in each panel is used to indicate the threshold where zero change in the relevant fiscal variable occurs. Above the line, countries increase the relevant fiscal variable; below the line, countries decrease the relevant fiscal variable. The red dots indicate the study’s crisis countries: Portugal, Ireland, Italy, Greece, and Spain. The red dots contrast with the blue dots which indicate non-crisis countries. The curved lines are generated by LOWESS regressions with a bandwidth of 0.6; the LOWESS regression lines present a summary of the data, weighting both variation within and across years. The red LOWESS line indicates the weighted average of the crisis countries; the blue LOWESS line indicates the weighted average of the non-crisis countries.



Deficit



Expenditure *Revenue*

Figure 1. Aggregate adjustment statistics for Eurozone countries over the study's sample between 2000 and 2013. The top panel shows the year-on-year percent change in the deficit as a percent of GDP. The bottom-left panel shows the year-on-year percent change in expenditure as a percent of GDP. The bottom-right panel shows the year-on-year percent change in revenue as a percent of GDP. Red dots indicate crisis countries: Portugal, Ireland, Italy, Greece, and Spain. Blue dots indicate non-crisis countries. In each panel, LOWESS regression lines with a bandwidth of 0.6 show a smoothed average of the relevant dependent variable; the red and blue lines indicate the weighted averages for crisis- and non-crisis countries, respectively.

In their changing deficits, crisis and non-crisis countries display broadly similar patterns. Prior to the crisis, on average, both sets of countries ran small deficits. In 2008, with the beginning of the financial crisis, the trend shifts sharply, as increasing deficits emerge across both sets of countries. The increase in deficits, which extended through 2009, purportedly constituted an initial Keynesian response to the financial crisis. At the EU-level, this impulse was captured by the European Economic Recovery Plan,[1] which sought to restore flagging demand with investment projects funded by the European Investment Bank (EIB). The EU's initial response has often been forgotten in the caricatured aftermath of Troika policy dominated by conservative policymakers in Berlin.

With respect to domestic policies, the Keynesian spirit is captured by a *Financial Times* article published in late 2008, "The undeniable shift to Keynes," which describes the leftward

[1] "A European Economic Recovery Plan." *EUR-Lex*, 26 November 2008. Web. < http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1439818628650&uri=URISERV:ec0004>.

shift against the economic orthodoxy captured in the Washington Consensus.[2] While the financial press hailed the Keynesian impulse as averting a repeat of the Great Depression, it is important to note that the pervasive increases in deficit did not result from the classical Keynesian vision of increased spending on the public sector to replace depressed consumption and investment.[3] The bottom two panels of Figure 1 indicate that the increase in deficits following the financial crisis did not reflect Keynesian orthodoxy. The increase in deficits reflected collapsing revenue to a far greater extent than increasing expenditure. This is a crucial point, given the conventional wisdom surrounding the crisis response. While the EIB implemented limited Keynesian measures, the response of Eurozone governments was not expansionary. Moreover, the bottom two panels underscore a fundamental difference between crisis and non-crisis countries. Prior to the crisis, crisis and non-crisis countries displayed similar behavior, with crisis countries increasing spending at a slightly higher pace than non-crisis countries. With the onset of the crisis, expenditure trends diverged, with crisis countries increasing spending at a slower pace and ultimately reducing spending in contrast to the relatively expansionary environments of non-crisis countries. The shift in spending and divergence between the sets of countries emerged as a response to the crisis. This is not the case with respect to revenue. The bottom-right shows that the divergence in government revenue emerged prior to the crisis. The divergence began in 2008, with crisis-country revenues increasing at a slower pace in 2008 and declining in 2009. While there was a partial recovery in the revenue generated by crisis-country governments after 2010, the crisis-country trends remained below that of the non-crisis countries.

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[2] Giles, Chris, Atkins, Ralph & Krishna Guha. "The undeniable shift to Keynes." *Financial Times*. 29 February 2008. Online.
[3] Keynes, John Maynard. *General theory of employment, interest and money*. Atlantic Publishers & Distributors, 2006.

These aggregate characteristics present an important empirical frame, consisting of three main points, that contrasts with the conventional wisdom surrounding how countries responded to the crisis. First, from the perspective of fiscal deficits, crisis and non-crisis countries looked remarkably similar prior to the financial crisis. To some extent, such similarity may be responsible for the post-accession convergence in bond yields analyzed in Chapter 4.[4] Second, the similarity in deficits, however, belied important differences in the fiscal environments of crisis and non-crisis countries. The former consistently spent and generated a larger portion of GDP from taxation. These twin tendencies offset each other in the aggregate but created a relatively fragile financial context in crisis countries, which rendered them particularly sensitive to the emergence of sovereign credit. Third, following the onset of the crisis, governments did not respond with classical Keynesian measures. While they may have been hailed as such in the financial press, the increased deficits stemmed from collapsing revenues rather than from a broad-based increase in government expenditure.

Disaggregated fiscal variables

Expenditure

As the discussion turns to different subcomponents of fiscal policy, it is important to bear in mind the empirical frame characterized by Figure 1. Figures 2 through 6 disaggregate the adjustment statistics further and demonstrate important heterogeneity among the sub-components of taxation and spending. Table 1 indicates that, on average, Eurozone countries spend 19.0% of GDP on social benefits and 10.5% of GDP on public-sector compensation. While the specific figures vary widely across the Eurozone, the high average values indicate a substantial

[4] It is difficult to distinguish to proportion of convergence attributable to the similarity in fiscal environments and the portion related to anticipated bailout of troubled countries by the EC, ECB, and Germany.

commitment of Eurozone governments to redistribution through employment and entitlements. This commitment is a hallmark of CME's in the typology of Hall & Soskice.[5]

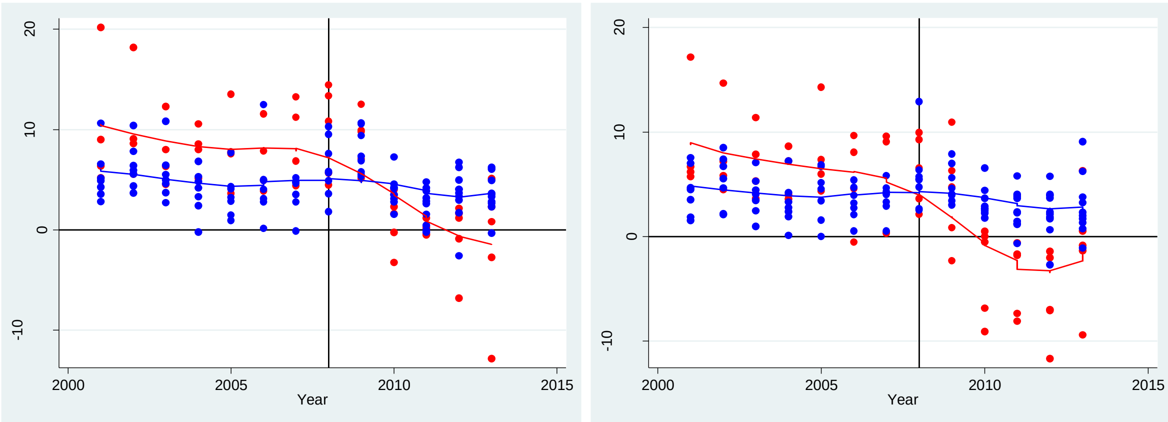

Figure 2. Disaggregated expenditure statistics for Eurozone countries over the study's sample between 2000 and 2013. The left panel shows the year-on-year percent change in spending on social benefits as a percent of GDP. The right panel shows the year-on-year percent change in public-sector compensation as a percent of GDP. Red dots indicate crisis countries; blue dots indicate non-crisis countries. In each panel, LOWESS regression lines with a bandwidth of 0.6 show a smoothed average of the relevant dependent variable; the red and blue lines indicate the weighted averages for crisis- and non-crisis countries, respectively.

Figure 2 presents the percent change in disaggregated components of government expenditure: the left panel indicates the year-on-year percent change in expenditure on social benefits, and the right panel indicates the year-on-year percent change in expenditure on public-sector compensation. Both expenditure subcomponents are standardized by GDP. With respect to social benefits as well as public-sector compensation, crisis and non-crisis countries behaved differently both prior to and following the crisis. Crisis countries were both more expansionary prior to the crisis and more contractionary following the crisis relative to non-crisis countries. These trends roughly map onto that observed in the bottom panels of Figure 1. The divergence between the two sets of countries is more apparent, both prior to and following the crisis, in the disaggregated components. Since these two subcomponents of expenditure constitute, on average, 64% of government expenditure over the sample, it is reasonable to assume that the

[5] Hall, Peter A., and David Soskice, eds. *Varieties of capitalism: The institutional foundations of comparative advantage*. Oxford University Press, 2001.

expenditure trends in Figure 1 are driven primarily by changes in social benefits and public-sector compensation.

Revenue

Table 2 presents summary statistics for a variety of different tax-related subcomponents. The table provides information related to income taxes, consumption taxes, social-security contributions, and corporate taxes. Together, these four categories constitute the vast majority of revenue collected by Eurozone governments. Table 2 provides two kinds of statistics related to each category of taxation: rate and revenue. As with the subcomponents of expenditure, tax revenues are standardized by GDP; rates are not standardized. Tax rates refer to the politically determined tax charged on some activity (e.g., earning income, consuming goods). Importantly, the partial equilibrium effect of a rate change may differ dramatically from the general equilibrium effect.[6] Revenues represent the macroeconomic aggregate of microeconomic decisions made by individuals and companies that consider, *inter alia*, tax rates. Because they are determined directly through a political process, rates are a more direct test of the political hypotheses proposed in Chapter 1. Revenues, which reflect a wider set of political and non-political considerations, are a less direct test of the explicitly political process described in Chapter 1.

On average, the highest marginal income-tax rate across Eurozone countries is 45.8%, the average consumption-tax rate is 19.4%. Revenues from these types of taxation generate, on average, 8.2% and 11.1% of GDP, respectively. The taxes that hit employers directly—social-security contributions and corporate taxes—are similarly high. Average social-security contributions are 36.8%, and average corporate-tax rates are 29.4%. Revenues from these types

[6] For example, tax rate cuts may increase output through their increase in demand. This, in turn, increases the taxable base, and hence revenue, even though the *ceteris paribus* effect of a rate cut is to reduce revenue.

of taxation generate, on average, 11.8% and 2.9% of GDP. These revenue figures provide a rough guide to the fiscal importance of each type of taxation to central governments across the Eurozone. Consumption and social security taxes, followed closely by income taxes, generate the most revenue. Corporate taxes, on the other hand, generate a small proportion of government revenue. These broad differences are important to bear in mind when interpreting the substantive importance of tax-rate changes in subsequent sections.

		Mean	**SD**	**Minimum**	**Maximum**
INCOME	RATE	45.7975	7.6354	19.0000	60.6000
	REVENUE	8.1923	2.7235	2.2520	14.0310
CONSUMPTION	RATE	19.3937	2.1453	15.0000	24.0000
	REVENUE	11.1388	1.2714	6.8380	14.5960
SOCIAL SECURITY	RATE	36.7581	10.7746	12.8000	55.5300
	REVENUE	11.8094	2.9417	3.6560	16.7510
CORPORATE	RATE	29.3911	7.1281	12.5000	51.6000
	REVENUE	2.9122	1.1574	0.5820	7.7840

Table 2. Summary statistics for categories of revenue. The first column indicates the relevant fiscal category; the row indicates either a rate or revenue, with the latter measured as a percent of GDP; the third column indicates the mean; the fourth column indicates the standard deviation; finally, the fifth and sixth columns indicate the minimum and maximum, respectively.

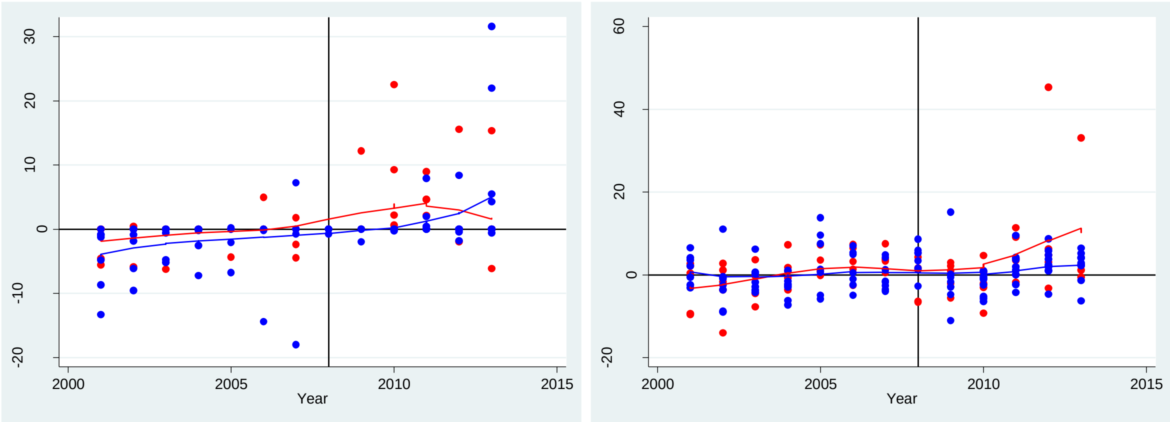

Figure 3. Income-tax statistics for Eurozone countries over the study's sample between 2000 and 2013. The left panel shows the year-on-year percent change in the income-tax rate for individual countries. The right panel shows the year-on-year percent change in revenue generated by income taxes within individual countries. See Figure 2's caption for further description.

Figure 1 shows that, in the aggregate, revenue as a proportion of GDP in both sets of countries maintained a steady, upward path; this is indicated by the distribution of observations above the horizontal axis in the bottom-left panel of Figure 1. Following the crisis, revenue in crisis countries dropped below that in non-crisis countries. Figures 3 through 6 present the constituent components that drive these aggregate trends. The left panel in Figure 3 shows that prior to the failure of Lehman Brothers, both crisis- and non-crisis countries implemented expansionary income-tax programs,[7] with both sets of countries reducing the top marginal income-tax rates. The crisis countries, on average, reduced income taxes by slightly less than non-crisis countries prior to the crisis. A more substantial difference emerges following the financial crisis, when crisis countries, on average, increased income-tax rates steadily. The right panel's revenue data underscores and provides nuance to the left panel's rate data. Although the divergence in rates predated the financial crisis, revenues of crisis and non-crisis countries diverged only starting in 2010.

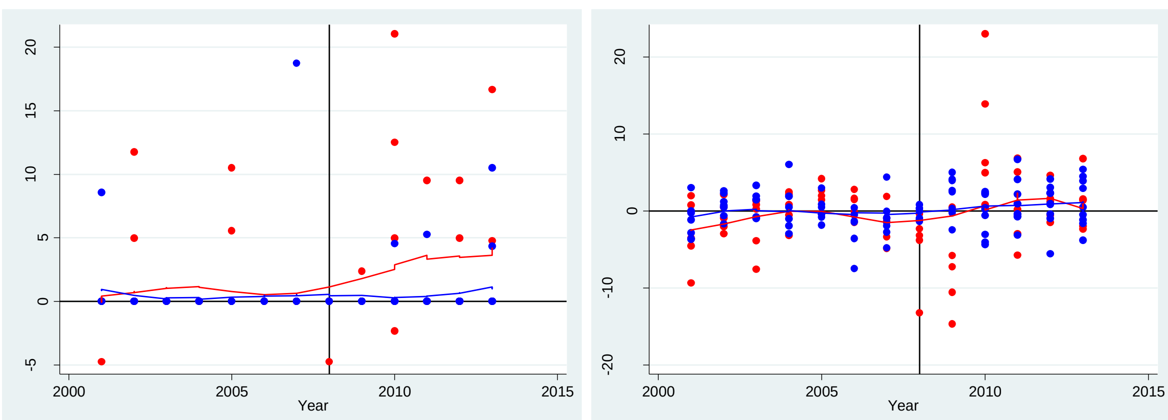

Figure 4. Consumption-tax statistics for Eurozone countries over the study's sample between 2000 and 2013. The left panel shows the year-on-year percent change in the consumption-tax rate for individual countries. The right panel shows the year-on-year percent change in revenue generated by consumption taxes within individual countries. See Figure 2's caption for further description.

Figure 4 shows the consumption-tax statistics over the sample. The left panel shows a clear regime change following the financial crisis in crisis countries. In non-crisis countries, rates

[7] See Romer for a discussion of the canonical neoclassical model and the neo-Keynesian synthesis. In the former, tax cuts have no effects because of Ricardian equivalence. In the latter, with the introduction of uncertainty over the future path of the economy and, by extension, tax rates, unexpected changes in tax rates can have real economic outcomes. The full citation is as follows: Romer, David. *Advanced Macroeconomics*. McGraw-Hill, 2011.

remained roughly the same following the crisis; in crisis countries, following the financial crisis, governments raised consumption-tax rates. Unlike with income- and corporate-tax rates, which declined prior to the financial crisis, consumption tax rates remained relatively constant prior to the crisis. On the right panel, the post-crisis divergence was not apparent in revenue, underscoring the weak fiscal positions of crisis governments with respect to consumption taxes. To collect comparable revenues to non-crisis countries, crisis countries raised consumption-tax rates relative to those in non-crisis countries.

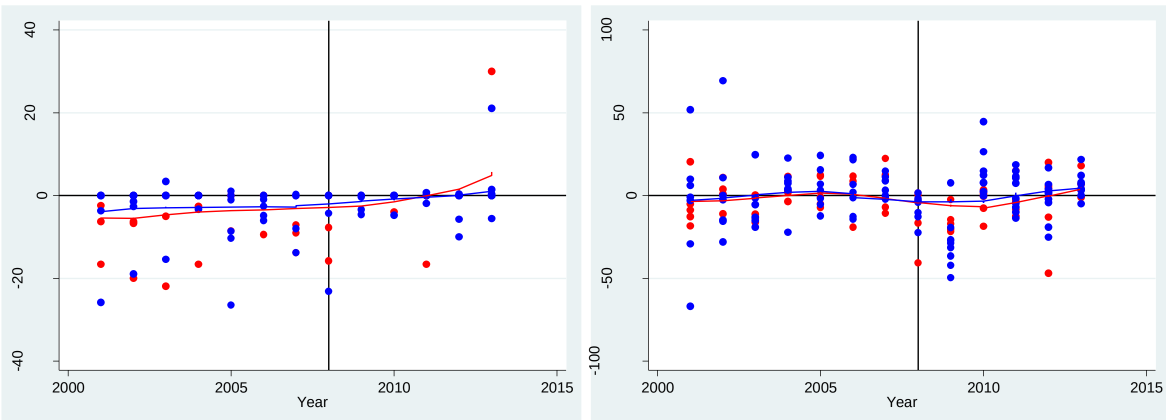

Figure 5. Corporate-tax statistics for Eurozone countries over the study's sample between 2000 and 2013. The left panel shows the year-on-year percent change in the corporate-tax rate for individual countries. The right panel shows the year-on-year percent change in revenue generated by corporate taxes within individual countries. See Figure 2's caption for further description.

Figure 5 shows the corporate-tax statistics over the sample. The left panel's rate statistics show that the pre-crisis trends in corporate-tax rates mirror the income-tax reductions observed in both crisis and non-crisis countries. Following the crisis, however, where income tax rates increased, corporate tax rates remained constant in both crisis and non-crisis countries. The right panel's revenue data show that revenues vary more than rates, although the percent changes remain centered on zero. When combined with Figures 2, 3 & 4, the corporate-tax burden in Figure 5 demonstrates clear distributional implications, in which the burden of adjustment shifts from corporate interests to the working and middle classes. This trend is apparent across the Eurozone and is not driven by any single country, although it is more pronounced among crisis countries. These trends provide some support for the convergence school of Garrett and Rodrik, in which the tax burden is shifted from mobile factors of production (capital) on to less mobile factors (labor).

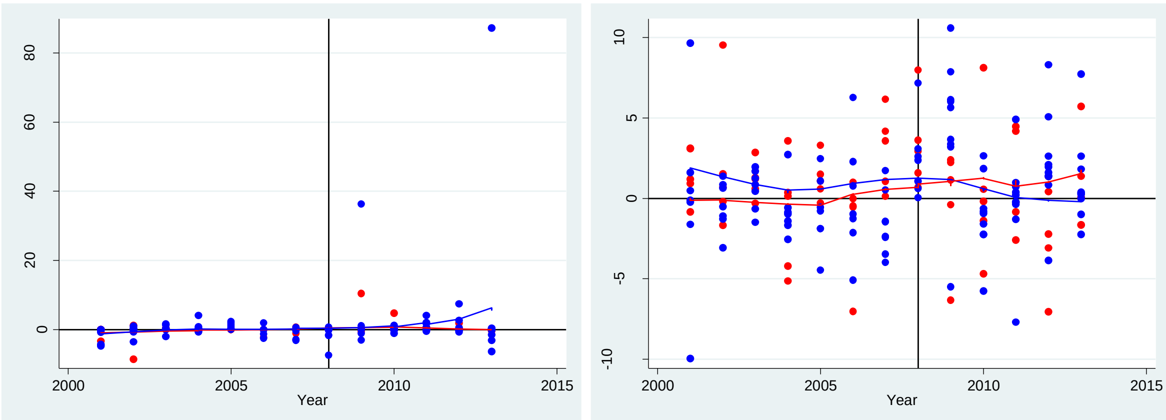

Figure 6. Social-security contribution statistics for Eurozone countries over the study's sample between 2000 and 2013. The left panel shows the year-on-year percent change in the social-security contribution rate for individual countries. The right panel shows the year-on-year percent change in revenue generated by social-security contributions within individual countries. See Figure 2's caption for further description.

Figure 6 shows the social-security contribution statistics over the sample. The left panel shows the relative stasis of social-security contribution rates. The relative stasis of rates contrasts sharply with the right panel's revenue data. The relative stability of rates relative to revenue suggests the outsized importance of macroeconomic, rather than political, factors in shaping social-security revenue relative to the revenue generated by other forms of taxation.

Theoretical implications

Figures 1 through 6 reveal important heterogeneity in the domestic adjustment regimes adopted following the financial crisis. Viewed in isolation, Figure 1 demonstrates the inadequacy of considering deficit as a sole measure of adjustment. The purported Keynesian response, identified by many observers appears, supported by the increased deficit in 2009. The bottom panels of Figure 1, however, show that the increased deficit resulted more from collapsed tax revenue than from increased expenditure. Further, the bottom two panels illustrate crucial differences between crisis and non-crisis countries. These differences are not apparent in the aggregate deficit data. The higher levels of spending and revenue in non-crisis countries rendered their position more precarious with respect to financial markets, in the case that sovereign credit risk emerged. This distinction between crisis and non-crisis countries meant that external actors and financial markets had an outsized effect in crisis countries relative their role in non-crisis countries. With tax rates already higher than in their non-crisis counterparts and a Laffer-curve dynamic likely to set in with further tax increases, crisis countries were particularly likely to face a fiscal crisis and require emergency funding from external actors. The variation in external-actor influence is a key theoretical point emphasized by Chapter 1's hybrid model and is explored in greater depth in Chapters 4 & 5.

The analytical bluntness that characterizes the initial domestic responses as Keynesian gives rise a similarly unsophisticated view that characterizes all austerity as identical, from both economic and political perspectives. Indeed, Figures 2 through 6 demonstrate a variety of ways to implement austerity. While the revenues responded in a relatively uniform manner, the political responses, in the form of changes in rates, varied sharply across Eurozone countries. Prior to the crisis, governments tended to reduce income and corporate tax rates while maintaining consumption and social-security rates. Following the crisis, however, while corporate and social-security rates remained constant, income- and consumption-tax rates increased across the sample. While there is important variation across countries and over time, on average, these data suggest that countries adjusted on the tax side primarily through changes in income- and consumption-tax rates. Figure 2 shows that, on the spending side, governments in crisis countries tended to reduce both social benefits and public-sector compensation following the onset of the crisis. In non-crisis countries, social benefits and public-sector compensation continued to increase following the crisis but at a slower rate than prior the crisis. The relative uniformity of responses among crisis countries illustrates central problems with the approaches of the convergence and VoC literatures. In both literatures, there is no attempt to account for variation in pressure of external economic forces over either time or space. In the convergence school, footloose capital places unrelenting pressure on capital-market regimes, producing similar economic-policy outcomes in all open economies. The convergence school thus has trouble explaining the differences in policy regimes between crisis and non-crisis governments. In a world governed by the dictates of footloose capital, all governments should respond similarly. Clear differences, however, emerged between crisis and non-crisis countries. In the VoC tradition, countries make the political choice to accept market forces (LME's) or to reject market forces (CME's). Within CME's, market forces play a marginal role. Thus, not only should there not be variation observed within CME's, but CME"s should also be insulated from financial-market shocks. Neither of these conditions hold over the crisis sample. A more realistic vision of the interaction between political actors, financial markets, and the production of fiscal policy is presented with Figure 7's hybrid model, which reproduces Figure 1 from Chapter 1. The model stresses the time-varying role of financial markets and, by extension, external actors in fiscal policymaking. Such variation helps to explain variation observed between crisis and non-crisis countries (a problem for convergence approaches) and within the CME crisis countries (a problem for VoC approaches).

Large-N inferential methods

The time-series trends suggest a clear distributional basis for adjustment following the 2008 financial crisis: income- and consumption-tax increases coupled with cuts to social benefits and public-sector compensation. These effects are primarily driven by policies adopted in crisis countries. Were these policies adopted because the right was in power in only crisis countries?

Or were bond yields so high that policy convergence occurred with respect to left and right governments within crisis countries? Proponents of an unreformed Meltzer-Richard model would answer yes to the former; proponents of the convergence literature would answer yes to the latter. The hybrid model suggests that the influence of external actors—an important driver of convergence—varies with financial-market pressure.

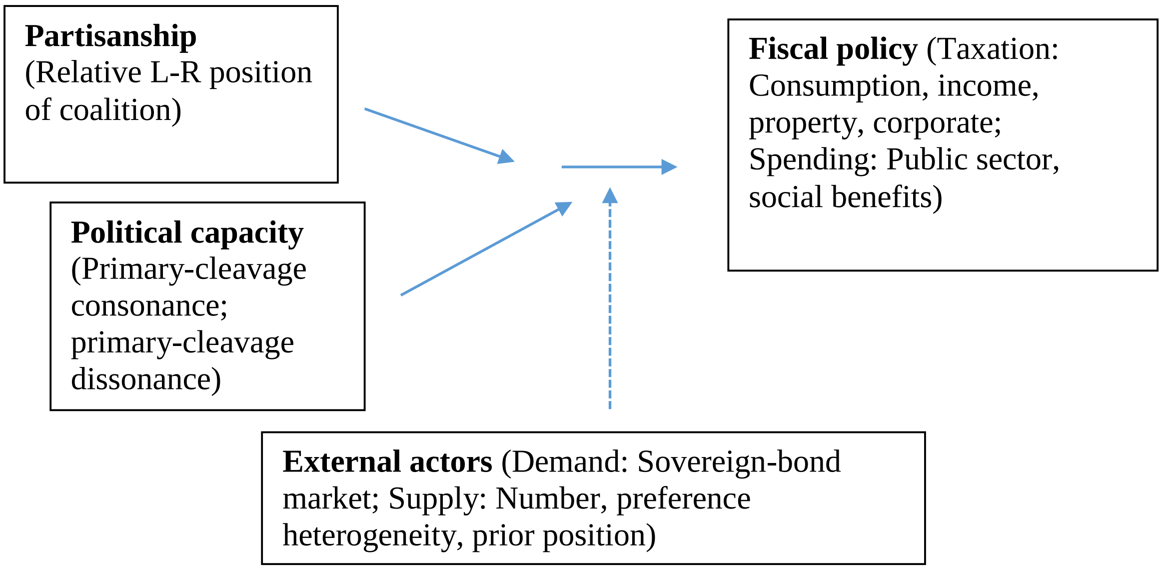

Figure 7. Schematic of the hybrid model's theoretical logic. Variables are listed in bold, with associated dimensions in parentheses.

While the examination of the time series of the fiscal variables reveals important variation, the narrative exploration of these series does not provide direct tests of the political and economic hypotheses that derived from the hybrid model. In the following sections, two direct tests of the hypotheses are introduced. First, t-tests display significant differences in the data. These t-tests consider the effect on fiscal policy of a single covariate at a time, thus having the disadvantage not controlling for covariates. They have the advantage, however, of being transparent in their implementation and requiring minimal assumptions regarding the specification of political and economic relationships. Second, by imposing further structure on the specification of the political and economic relationships over the sample, fixed-effects regressions identify the effects of political and economic variables while controlling for covariates. The relevant variation is dramatically reduced compared with the t-test approach, because fixed-effects regression identify effects on the basis of within-country variation over time. Thus, the between-country variation leveraged with t-tests remains unexploited. Each approach generates specific advantages and disadvantages, which should be borne in mind when interpreting the subsequent results.

Partisan hypotheses: t-tests

	Left		**Right**		**Convergence**	**Hypothesis**	**t-stat**	**p-value**
Dependent variable	Mean	SE	Mean	SE				
Deficit	-2.6112	0.5110	-3.0349	0.4757	L=R	L != R	0.5929	0.5540
Expenditure	46.5594	0.9822	45.2581	0.9058	L=R	L > R	0.9545	0.1706
Revenue	43.9476	0.8297	42.2232	0.7532	L=R	L > R	1.5126	0.0661
DISAGGREGATED EXPENDITURE								
Social benefits	19.5861	0.4511	18.5696	0.4742	L=R	L > R	1.4865	0.0695
Public-sector compensation	10.6497	0.2599	10.4373	0.2481	L=R	L > R	0.5756	0.2828
DISAGGREGATED TAXATION								
Income	46.1506	0.9074	45.5770	0.7121	L=R	L < R	0.5040	0.3074
Revenue	8.7244	0.3580	7.8862	0.2316	L=R	L < R	2.0551	0.0207
Consumption	19.0684	0.2493	19.6574	0.2001	L=R	L < R	-1.8612	0.0322
Revenue	10.9556	0.1647	11.2475	0.1122	L=R	L < R	-1.5182	0.0654
Corporate	31.6038	0.6292	27.5993	0.7325	L=R	L > R	3.9580	0.0001
Revenue	2.9504	0.1220	2.8722	0.1208	L=R	L > R	0.4430	0.3292
Social security	39.2018	1.1358	34.8383	1.0567	L=R	L > R	2.7761	0.0030
Revenue	12.750	0.2084	11.1850	0.3310	L=R	L > R	3.6143	0.0002

Table 3. Difference-in-means tests for hypotheses related to partisanship. All tests are one-tailed except for that related to the aggregate deficit. Table 3 is divided into three sections: aggregated fiscal measures; disaggregated expenditure measures; and disaggregated taxation measures (with the latter two indicated by bold headers). The first column indicates the relevant dependent variable. The next four columns indicate the mean and standard error of estimates by variety of partisanship. The sixth column indicates the hypotheses implied by the convergence literature. The seventh column indicates the hypotheses implied by the hybrid model. The eighth and ninth columns indicate the t-statistic and p-value from t-tests.

The first set of hypotheses relates to the aggregated fiscal statistics. The sixth and seventh columns of Table 3 state the hypotheses implied by a number of different theoretical perspectives. The sixth column indicates the hypotheses of the convergence literature.

Convergence theories anticipate no differences across fiscal categories. The symmetry with respect to partisanship effects stems from the capital mobility posited by the literature and the closely associated phenomenon of footloose capital. These dynamics drive all countries to adopt similar fiscal environments. The seventh column indicates the hypotheses implied by Figure 7, when combined with the distributional logic of Table 1 from Chapter 1, reproduced here as Table 4. Table 4 presents the preferences over fiscal policies exhibited by different groups of individuals, differentiated on the basis of primary source of income. These groups, in turn, form the primary bases of mainstream parties across the study's sample.

Party/Position on various measures	**Favored tax increases**	**Opposed tax increases**	**Favored spending cuts**	**Opposed spending cuts**
Corporate	Consumption, income	Property, social-security	Public sector, social benefits	NONE
Middle class	Consumption, corporate	Income, Social-security	Public sector, social benefits	NONE
Public sector	Corporate, Social-security	Income, consumption	NONE	Public sector, social benefits
Working class	Corporate, Social-security	Income, consumption	Public sector	Social benefits

Table 4. Policy preferences (columns) by party (rows). The first column lists the four primary constituencies considered in the present study: corporate, middle class, public sector, and working class. The second and third columns indicate opposing positions on tax increases; the fourth and fifth columns indicate opposing positions on spending cuts. Within each cell are particular policy measures.

The hybrid model—the schematic version of which is reproduced in Figure 7—implies a number of hypotheses. Figure 7's model is agnostic on the deficit but predicts higher levels of expenditure under left governments than right governments. This stems from the preferences, shown in Table 4, of the core constituencies of left parties. The working class and public sector favor spending on both social benefits and public-sector compensation. With respect to revenue, Figure 7's prediction is driven by left government's higher demand for expenditure. However, particularly given the low post-accession interest rates analyzed in Chapter 4, much of current expenditure is financed with capital-market borrowing. A simple accounting identity illustrates the relationship between these variables: *Expenditure = Revenue + Borrowed funds*. Thus, particularly in the pre-accession period, expenditure is not constrained by revenue. The capital-market constraints bind to a larger extent following financial crises when bond-yield spreads increase. The hybrid model seeks to explicitly account for the variation in capital-market pressure, an important step forward compared with past approaches to the study of fiscal policy. The distributional logic of Table 4 suggests that left parties favor a relatively higher burden of revenues constituted by corporate taxes and social-security contributions; right parties favor a relatively higher burden of revenues constituted by consumption and income taxes.

The data largely support these hypotheses. Left governments spend more than right governments (46.6% of GDP compared with 45.3% of GDP), although the difference is not statistically significant at the 10%-level (p-value of 0.171). On the revenue side, to cover their higher expenditures, left governments collect significantly (p-value of 0.066) more taxes than right governments (43.9% of GDP compared with 42.2% of GDP). In the aggregate, there is not a statistically significant difference in the deficit. This is an important corrective to the conventional wisdom that left governments run larger deficits than right governments. Such indeterminacy results from one of the key insights of the hybrid model, which implies that governments do not have direct preferences over the size of the deficit. Rather, governments have preferences over components of the deficit; the effect of partisanship on the deficit depends on how preferences over the various subcomponents aggregate.

Below the aggregated fiscal statistics, Table 3 displays hypotheses related to disaggregated measures of expenditure. The results, to some extent, confirm the hybrid model's hypotheses. On the one hand, left governments spend significantly (p-value of 0.070) more than right governments on social benefits (19.6% of GDP compared with 18.6% of GDP). On the other hand, left and right governments do not spend significantly (p-value of 0.283) different amounts on public-sector compensation (10.6% of GDP compared with 10.4% of GDP). The disaggregated expenditure helps to explain the insignificance of the aggregate expenditure results related to partisanship. The sharp division between parties on social-benefits expenditure is diluted by the similarity between parties with respect to public-sector compensation. The insignificance of partisanship's effect on public-sector compensation may reflect the right's co-optation of the public sector in particular countries over the sample period.[8] Chapters 6 & 7 of Portugal & Spain and Italy & Greece, respectively, explore this variation in greater depth.

The final section of Table 3 presents results related to disaggregated revenue statistics. The hybrid model implies different outcomes over the various subcomponents of government revenue. Table 4 implies that, while left governments collect more taxes in the aggregate than right governments, left governments favor lower income and consumption taxes. In addition, right governments favor lower corporate taxes and social-security contributions. Table 3, subject to a number of caveats, bear out these hypotheses. Contrary to conventional accounts, left governments do not have significantly (p-value of 0.307) higher income-tax rates than right governments (46.2% of income compared with 45.6% of income); this null result is particularly problematic for the conventional, because the measure employed here is the highest marginal income-tax rate. According to partisan MR logic, left governments should display unambiguously higher income-tax rates than right governments. *A fortiori*, the MR logic applies to the highest marginal income-tax rate. On average, however, left governments generate significantly (p-value of 0.021) more revenue from income taxes than right governments (8.7% of GDP compared with 7.8% of GDP). As the theory predicts, consumption-tax rates are

[8] Portugal is alone among crisis countries in having right governments spend significantly (p-value of 0.001) more on the public sector than left governments (12.8% of GDP compared with 10.8% of GDP). When Portugal is excluded from the sample, left governments spend significantly (p-value of 0.091) more on public-sector compensation than right governments (10.6% of GDP compared with 10.1% of GDP).

significantly (p-value of 0.032) higher under right governments (19.7% of purchase price compared with 19.1% of purchase price). These higher rates, in turn, generate significantly (p-value of 0.065) higher revenues from consumption taxes under right governments (11.2% of GDP compared with 11.0% of GDP).

Table 3 next presents those taxes expected to be higher under left governments than right governments: corporate taxes and social-security contributions. Left governments set significantly (p-value of 0.000) higher corporate-tax rates (31.6% of corporate profits compared with 27.6% of corporate profits). These higher rates generate more revenue (2.95% of GDP compared with 2.89% of GDP), but the difference is not statistically significant (p-value of 0.329). Left governments also assess significantly (p-value of 0.003) higher social-security contributions compared with right governments (39.2% of the wage bill compared with 34.8% of the wage bill). These higher rates, in turn, generate significantly (p-value of 0.000) more revenue (12.8% of GDP compared with 11.2% of GDP.

Overall, Table 3's t-test results support the hybrid model. Both the model and the empirical results show governments with nuanced preferences over fiscal. Crucially, these governments do not have direct preferences over the size of the deficit. Rather, governments have preferences over different components of the deficit which, in turn, shape preferences over the deficit. In contrast to the convergence approach, significant variation over fiscal-policy outcomes emerges with respect to partisanship. This stands in contrast to a world in which partisan differences are competed away in an attempt to attract footloose capital.

Partisan and political-capacity hypotheses: Fixed-effects regressions

The results in Table 3 illuminate a picture of fiscal adjustment more nuanced than that implied by either orthodox macroeconomic prescriptions or past approaches in the literature. The hybrid model underscores two relevant conditioning variables: programmatic consonance and the bond-yield environment. A simple comparison-of-means, as performed in Table 3, ignores both of these conditioning variables. Table 5's analysis takes both conditioning variables into account. The section first presents findings within consonance groupings before turning to differences between consonance groupings. Finally, the discussion turns to the effect of the bond-yield environment on fiscal policy. A more thorough examination of the bond-yield environment, however, is reserved for Chapter 4 & 5.

Table 5's fixed-effects regressions control for covariates are ignored in Table 3's t-tests. However, the regressions rely only on within-country variation to identify effects. Tables A1 & A2, presented in the appendix to this chapter, display the study's core regression results. In all specifications, GDP is included to capture differences in the macroeconomic environment between countries and over time. MODRILE, which extracts the economic component from the CMP's RILE measure, is the primary measure of partisanship. CONSONANCE is used as a measure of programmatic consonance and captures the degree of difference among parties in government with respect to MODRILE. MODRILE*CONSONANCE is an interaction term of the two variables that captures the effect of partisanship at different levels of programmatic consonance. BOND-YIELD is a continuous variable that captures the effect of financial-market pressure on governments.

Consonance reflects the policy agreement among political parties within a governing coalition. Where consonance is high, parties agree on economic policy; where consonance is low, parties disagree on economic policy. High-consonance governments tend to be single parties or coalitions of closely aligned political parties.[9] Low-consonance governments tend to be

[9] Spain's post-crisis, PP-led government provides an example of the former; Portugal's post-crisis, PSD-CDS/PP-led government provides an example of the latter.

large coalitions of parties, in which governing parties expressing substantial differences on economic policy.[10] Thus, there is a structural relationship between consonance and partisanship, which can be seen in Figure A1 of the appendix to this chapter. Where the partisanship of a governing coalition is located at either end of the political spectrum (either left or right), consonance tends to be high. Where partisanship is located in the middle of the spectrum, consonance tends to be low. The collinearity induced by the structural relationship makes it difficult, if not impossible, to separately identify the effects of the two variables. Interpreting the regression results in Tables A1 & A2 requires taking the structural relationship between consonance and partisanship into account. Thus, Table 5 presents the marginal effects of partisanship for different levels of partisanship. The subsequent analysis closes with an extended discussion of unconditional marginal effects that disregard the structural relationship between consonance and partisanship.

Dependent variable	**Low-consonance (0.25)**	**p-value**	**High-consonance (0.75)**	**p-value**
Deficit	0.046 (0.047)	0.337	0.038 (0.135)	0.780
Expenditure	-0.111 (0.066)	0.048	-0.071 (0.189)	0.354
Revenue	-0.065 (0.037)	0.041	-0.034 (0.106)	0.377
[redacted]				
Social benefits	-0.054 (0.030)	0.038	-0.030 (0.087)	0.365
Public-sector compensation	-0.018 (0.013)	0.079	-0.012 (0.036)	0.366
[redacted]				
Income	-2.370 (2.224)	0.144	-0.556 (4.382)	0.500
Revenue	-0.115 (0.524)	0.413	-0.227 (1.064)	0.416
Consumption	-0.503 (0.844)	0.276	0.687 (1.712)	0.344

[10] The post-crisis grand coalition of PDL-Democrats in Italy provides an example.

Revenue	-0.720 (0.458)	0.059	0.024 (0.929)	0.490
Social-security contributions	-1.045 (0.581)	0.037	-0.770 (1.178)	0.257
Revenue	-0.147 (0.407)	0.359	-0.085 (0.826)	0.459
Corporate	6.090 (2.994)	0.022	2.880 (6.075)	0.318
Revenue	0.388 (0.546)	0.239	0.108 (1.107)	0.461

Table 5. Marginal effects on various fiscal-policy variables of a shift in partisanship of government differentiated by levels of consonance. The first column indicates the relevant dependent variable. The filled-in cells separate the table by the study's three sets of dependent variables: aggregated fiscal policy; disaggregated expenditure components; and disaggregated revenue components. The second column indicates the marginal-effect estimates for low-consonance political contexts; roughly, this corresponds to the difference between a socialist-led coalition government and a conservative-led coalition government. The fourth column indicates the marginal-effect estimates for high-consonance political contexts; roughly, this corresponds to the difference between a socialist single-party majority and a conservative single-party majority. In the second and fourth columns, mean estimates are presented with standard errors in parentheses. The third and fifth columns indicate the p-values for the hypothesis tests; all are one-tailed, except with respect to the aggregate deficit, which is two-tailed.

Low-consonance results

Table 5 displays the marginal effect on a variety of fiscal-policy dependent variables of shifting from a left to a right government. The first column lists the relevant dependent variables; the second and fourth indicate marginal effects, with standard errors in parentheses, for low- and high-consonance governments, respectively.[11] Among low-consonance governments, center-right governments run 4.6 percentage point (ppt) lower deficits than center-left governments,

[11] The low-consonance marginal effect of a shift in partisanship is calculated with the following equation: MARGINAL EFFECT = (0.5*MODRILE + 0.25*CONSONANCE + 0.5*MODRILE*0.25*CONSONANCE) – (0.25*CONSONANCE) = (0.5*MODRILE + 0.5*MODRILE*0.25*CONSONANCE). The two parenthetical terms represent estimates of fiscal policy under right and left governments respectively. Subtracting the two thus gives an estimate of the marginal effect of partisanship on a given type of fiscal policy. The 0.5's in the first parenthetical term reflect the structural relationship between consonance and partisanship. In a low-consonance setting, partisanship scores are closer to the mean partisanship score of 0.50 than in high-consonance settings, when partisanship scores are distributed at the peripheries near 0 and 1. Scaling MODRILE by 0.5 in low-consonance settings thus reflects that a shift in partisanship in the low-consonance context would be a shift from center-left to center-right, rather than a shift from left to right. Similarly, scaling CONSANANCE by 0.25 reflects the low-consonance environments. The marginal effect of a shift in partisanship in a high-consonance setting is calculated with the following equation: MARGINAL EFFECT = (1.0*MODRILE + 0.75*CONSONANCE + 1.0*MODRILE*0.75*CONSONANCE) – (0.75*CONSONANCE) = (1.0*MODRILE + 1.0*MODRILE*0.75*CONSONANCE). In contrast with the low-consonance estimate, MODRILE is not scaled, because a shift from left to right in the high-consonance context would correspond to a shift between left (MODRILE=0) and right (MODRILE=1), rather than between center-left (MODRILE=0.25) and center-right (MODRILE=0.75). Finally, scaling CONSONANCE by 0.75 reflects the high-consonance context.

although the difference is not statistically significant (p-value of 0.337). This complements the t-test's lack of partisanship-decisiveness with respect to the deficit. As in Table 3's t-tests, the difference in deficits reflects both significantly lower expenditures and revenues among center-right governments. A shift from a center-left to a center-right government reduces expenditures by 11.1 ppt's (p-value of 0.048) and revenue from taxation by 9.0 ppt's (p-value of 0.041). The difference in expenditures between center-left and center-right governments is driven both by lower expenditures on social benefits and public-sector compensation under center-right governments. A shift from center-left to center-right government reduces spending on social benefits by 5.4 ppt's (p-value of 0.038) and public-sector compensation by 1.8 ppt's (p-value of 0.079). Both effects are statistically and substantively significant. These results reinforce and refine the t-test results. Controlling for bond-yields, consonance, and GDP, spending on social benefits remains robustly significant and spending on public-sector compensation becomes significant.

The difference in revenues among low-consonance governments is driven by a combination of effects. Low-consonance, center-left governments assess significantly higher income taxes, consumption taxes, and social-security taxes, although only the effect of partisanship on social-security taxes is significant. A shift between center-right and center-left governments increases income taxes by 2.4 ppt's (p-value of 0.144), consumption taxes by 0.5 ppt (p-value of 0.276), and social-security contributions by 1.0 ppt (p-value of 0.037). Problematically, a shift to the center-left reduces corporate taxes by 6.1 ppt's (p-value of 0.022). Subsequent section discuss the anomalous findings with respect to corporate taxes. These differences in rates correspond to differences in revenue in the expected directions: higher income, consumption, and social-security taxes generate higher revenues; lower corporate taxes generate lower revenue. However, the only significant revenue effect is with respect to consumption taxes (p-value of 0.059).

High-consonance results

As in the case of low-consonance governments, right governments in high-consonance settings run lower deficits than left governments; the difference between the two types of governments is roughly 3.8 ppt's. Right governments spend 7.1 ppt's less than left governments. In concert with the differences in expenditure, right governments generate 3.4 ppt's less revenue than left governments. With respect to social benefits, on average, right governments spend 3.0 ppt's less than left governments. With respect to public-sector compensation, right governments spend 1.2 ppt's less than left governments. On the tax side, in high-consonance settings, income taxes and social-security contributions are lower under right governments. Consumption and corporate rates are higher under right governments. In the aggregate, these differences in tax burden in high-consonance settings lead to higher aggregate revenue among left governments. In contrast to the broad-based statistical significance observed in the low-consonance context, none of the high-consonance marginal effects are significant. Thus, the significance of the findings in the aggregate, as shown in Tables A1 and A2, are driven by significant effects in low-consonance settings. The final section explores both the reasons for and the implications of the difference in statistical significance between the two settings.

External actors

In addition to the hybrid model's hypothesized effects of partisanship and consonance, the model suggests that external actors play a significant role in shaping fiscal-policy outcomes. In this chapter, bond yields measure the influence of external actors and captures the degree to which countries rely on alternative sources of funding. In high-yield environments, there is a higher probability that governments will resort to external actors for funding. In the regression context, however, bond yields are included only as a control. As Figure 7's schematic suggests, the influence of external actors depends on complicated mixture of supply- and demand-side factors, which are difficult to capture in a regression framework. The remaining chapters, through a variety of quantitative and qualitative approaches, evaluate the effects of bond-yield pressure, and thus external actors, on fiscal-policy outcomes.

Theoretical implications

The various preferences in Table 4 manifest in different fiscal policies adopted by different types of political parties in response to financial crises. These varying responses underscore problems with each of the three dominant approaches to characterizing fiscal policy: partisan MR; convergence; and VoC. Left and right governments behave in distinct manners, as implied by a partisan MR model. The results in Chapter 3 suggest that Chapter 1's hybrid model outperforms an unreformed MR model, because the hybrid model incorporates insights borrowed from both the convergence and VoC approaches. From the former, the hybrid model incorporate the importance of external actors, as mediated by financial markets. From the latter, the hybrid model incorporates a more sophisticated understanding of domestic politics with respect to coalition politics. Such dynamics are particularly important in the context of the Eurozone's, predominantly parliamentary, politics. The time-series analysis, t-tests, and fixed-effects regressions grant an increasingly refined picture of how governments respond to crisis using fiscal policy. The remaining two subsections discuss two potentially problematic findings for the hybrid model: the limited significance of consonance in the fixed-effects regressions and the marginal effect of partisanship on corporate-tax rates.

The limited role of consonance

Contrary to theoretical expectations, consonance appears to have little conditioning effect on partisanship's shaping of fiscal-policy outcomes. The hybrid model predicts that an increase in consonance should intensify the effect of partisanship on fiscal-policy outcomes; Table 5's results, however, display no such effects. There are a number of potential explanations for consonance's broad insignificance. Two of the most important are mismeasurement and misspecification. Mismeasurement would be a problem, even if the theoretical relationship between partisanship, consonance, and fiscal policy is correctly specified in the hybrid model. As discussed, the structural relationship between consonance and partisanship renders the separate measurement of the two variables particularly difficult. By definition, consonance is high when partisanship adopts extreme values; consonance is low for intermediate values of partisanship. The collinearity between the two renders identification of separate effects particularly difficult.

The insignificance of consonance may also stem from misspecification. Indeed, Figure 7's emphasis on the distinction between left/center-left and right/center-right may be overstated. For example, there may be little difference in the fiscal-policy outcomes between left and center-left governments, if left parties hold the relevant fiscal-policy portfolios in either case. Coalition governments would produce similar policy to single-party governments of the same partisan hue, if each minister operated with relative independence over either his or her portfolio.[12] Moreover, even when coalition partners take significant fiscal-policy portfolios, their views may be ignored. This has been the case in Ireland's post-crisis Fine Gael-Labour coalition government. The Labour party held two important portfolios related to fiscal policy: Public Expenditure and Reform; and Social Protection. Notwithstanding their possessing key portfolios, Leahy

[12] The relative autonomy of ministers with respect to their portfolio is a common assumption in the literature on parliamentary politics. For a representative example, see the following: Laver, Michael, and Kenneth A. Shepsle, eds. *Making and breaking governments: Cabinets and legislatures in parliamentary democracies*. Cambridge University Press, 1996.

documents Labour's frustration in systematically being ignored and boxed out of discussions over and discussions related to fiscal policy.[13] Similar tension occurred in Ireland's three-party pre-crisis coalition government. Fianna Fail dominated fiscal-policy decisions. Such unilateral domination eventually led to the Green Party's departure from the coalition and February 2011's general elections.

An anomaly: Higher corporate-tax rates under right governments?

The findings with respect to corporate taxation appear to contravene the hypotheses by Table 4 motivated by the distributional consequences of fiscal policy. Table 5 ostensibly suggests that a shift to the right increases corporate-tax rates. However, in interpreting Table 5's results, it is important to bear in mind the trends identified in Figure 5, which shows the time series of changes in corporate-tax regimes. Figure 5 shows a broad-based, pre-crisis reduction in corporate-tax rates. Following the crisis, corporate-tax rates remained steady. Because right governments came to power as a result of post-crisis, anti-incumbent sentiment, a decontextualized interpretation of Figure 5 and Table 5's regression analysis implies that right governments impose higher corporate taxes relative to left governments. Instead, a more sophisticated reading suggests that the results in Table 5 reflect the expansionary pre-crisis financial environment, in which left parties implemented broad-based expansionary measures. In the post-crisis period, right parties held corporate taxes in place to the relative benefit of corporations; this contrasts with the elevated taxes targeted towards other constituencies. Thus, right governments favored corporations in the post-crisis period, even though, by comparison, they appeared to treat corporations unfavorably compared with pre-crisis left governments which operated under a different set of financial constraints. This interpretative difficulty underscores

[13] Leahy, Pat. *The Price of Power: Inside Ireland's Crisis Coalition*. Penguin UK, 2013.

the broader problem of relying only on large-N, quantitative approaches that either ignore or obscure political context. Chapters 5, 6 & 7 foreground qualitative approaches that reduce the risk of faulty inferences which emerge from either ignored or misunderstood context.

Appendix to Chapter 3

	DEFICIT	EXPENDITURE	REVENUE	SOCIAL BENEFITS	COMPENSATION
GDP (in billions of Euro)	-0.000151**	0.000546***	0.000395***	0.000256***	0.0000947
t-statistic	-2.33	6.01	7.72	6.13	5.51
MODRILE	0.118	-0.297***	-0.179***	-0.148***	-0.0472**
t-statistic	1.58	-2.85	-3.06	-3.09	-2.39
CONSONANCE	0.0906**	-0.233***	-0.143***	-0.107***	-0.0352***
t-statistic	2.01	-3.7	-4.02	-3.69	-2.95
MODRILE*CONSONANCE	-0.107	0.302***	0.194***	0.157***	0.0467**
t-statistic	-1.33	2.66	3.05	3.02	2.18
BOND-YIELD	-0.00399*	0.00428	0.00029	0.00205	-0.0000821
t-statistic	-1.73	1.32	0.16	1.38	-0.13
CONSTANT	0.0239	0.202**	0.226***	0.0645*	0.0627***
t-statistic	0.4	2.42	4.8	1.68	3.96
OBSERVATIONS	152	152	152	152	152

Table A1. Regression of aggregated adjustment measures and expenditure subcomponents on theoretical measures discussed in Chapter 1. Dependent variables are listed across the columns in the first row; independent variables are listed along the rows. The panel regression employs robust standard errors clustered at the country level. Asterisks indicate varying levels of significance: *, p < 0.10; **, p < 0.05; and ***, p<0.01.

	INCOME		CONSUMPTION		SOCIAL SECURITY		CORPORATE	
	RATE	REVENUE	RATE	REVENUE	RATE	REVENUE	RATE	REVENUE
GDP	-0.0130***	0.00211**	0.00904***	-0.000993	-0.00113	0.000933	-0.0438***	-0.000601
t-statistic	-3.33	2.33	6.22	-1.26	-1.13	1.33	-8.48	-0.64
MODRILE	-6.833	-0.232	-1.853	-2.171**	-2.750**	-0.398	16.83***	1.109
t-statistic	-1.52	-0.22	-1.11	-2.39	-2.39	-0.49	2.83	1.02
CONSONANCE	-6.704**	-0.238	-2.942***	-1.657***	-0.804	-0.737	12.47***	0.452
t-statistic	-2.48	-0.38	-2.91	-3.02	-1.16	-1.51	3.47	0.68
MODRILE* CONSONANCE	8.370*	0.00649	3.387*	2.926***	2.640**	0.418	-18.60**	-1.335
t-statistic	1.72	0.06	1.87	2.97	2.11	0.48	-2.89	-1.14
BOND-YIELD	0.816***	0.0567*	0.221***	0.00741	0.0765**	-0.0200	-0.281	-0.00836
t-statistic	6.19	1.83	4.48	0.28	2.26	-0.84	-1.61	-0.26
CONSTANT	59.81***	6.842***	13.35***	13.13***	40.30***	11.81***	56.08***	2.805***
t-statistic	16.96	8.33	10.12	18.37	44.43	18.59	11.78	3.28
OBSERVATIONS	156	154	156	155	156	155	156	154

Table A2. Regression of disaggregated revenue measures on theoretical measures discussed in Chapter 1. Dependent variables are listed across the columns in the first row; independent variables are listed along the rows. The panel regression employs robust standard errors clustered at the country level. Asterisks indicate varying levels of significance: *, p < 0.10; **, p < 0.05; and ***, p<0.01.

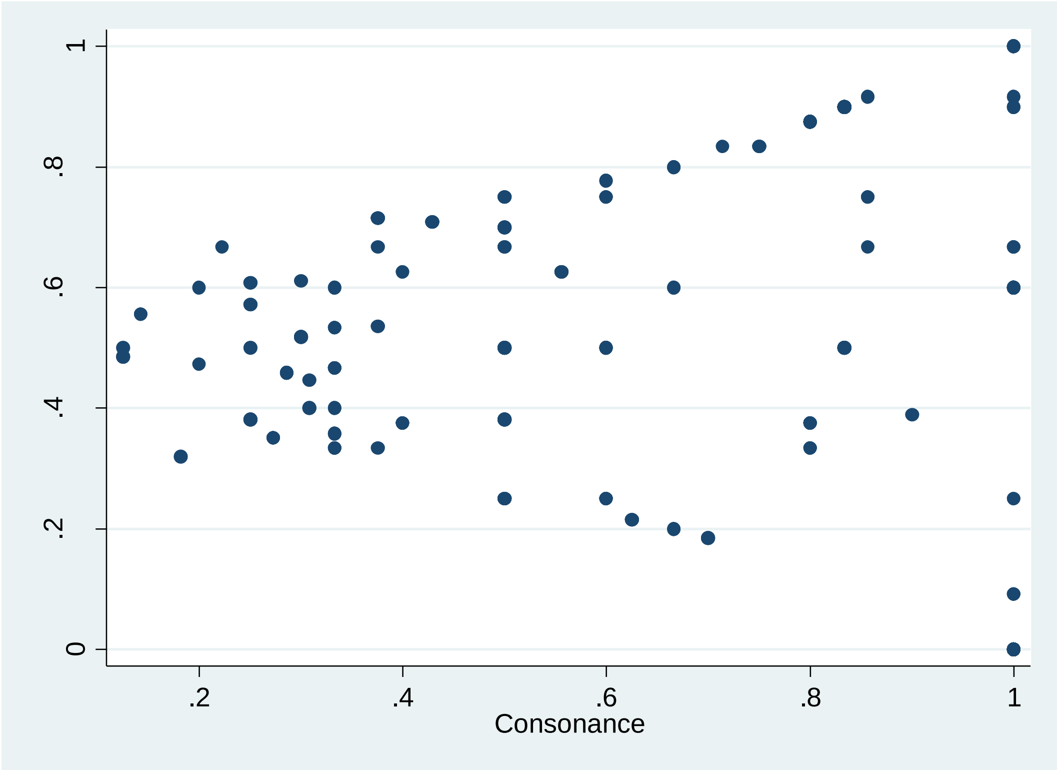

Figure A1. MODRILE and consonance over the sample. Extreme values of MODRILE (either high or low) tend to be associated with high levels of consonance. Intermediate values of MODRILE tend to be associated with intermediate levels of consonance.

Chapter 4: Bond yields, correlation structure, and the financial crisis

Introduction

The present chapter details important indirect evidence related to adjustment policy in the Eurozone. Bond yields are a measure of domestic politicians' susceptibility to the pressure of external financial actors. In the context of Figure 1, bond yields capture the degree to which the dashed arrow acts as a binding constraint on domestic governments. Yields indicate the cost of funds on capital markets; when these rates are prohibitively high, governments either adjust internally or turn to external actors. With the relatively long time horizon of internal fiscal adjustment (i.e., the fiscal gains from tax increases and spending cuts take time to materialize) and the immediate threat of default, bond yields provide a rough measure of domestic policymakers' demand for funds from external actors. This chapter thus documents the variation in pressure faced by domestic policymakers across the crisis sample.

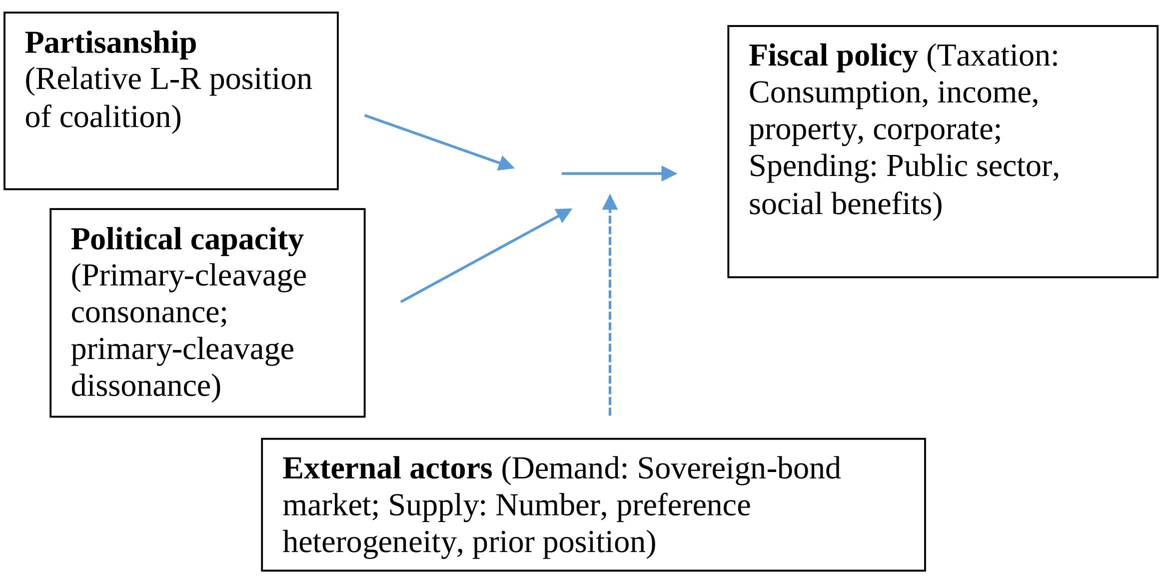

Figure 1. Schematic of the hybrid model's theoretical logic. Variables are listed in bold, with associated dimensions in parentheses.

In addition, Chapter 4 formally addresses the ubiquitous notion of a homogenous "PIIGS." While subsequent chapters discuss the policy heterogeneity of these regimes, the present chapter demonstrates that financial markets treated each of the countries with a remarkable degree of nuance. While correlation between debt yields fluctuated throughout the crisis, reflecting variable degrees of contagion risk, bond markets differentiated between sovereigns to a far greater extent than is recognized by the popular press. Such differentiation appeared particularly prominent late in the crisis period.

The remainder of Chapter 4 is divided into four sections. The first section provides an overview of the role of bond yields in and following the crisis. In particular, the section presents explanations found in the literature on financial crises and fiscal policy. The second section presents summary statistics of bond-yield data over the study's sample. The third section contains the empirical core of the chapter and presents factor analyses of bond yields over the entire period along with a variety of subsamples. The fourth section concludes the chapter and emphasizes how the analytical results differ from the conventional narrative produced by the media.

Overview

Bond yields are important for a variety of reasons. Not least, because politicians pay close attention to them. This is particularly the case during periods of economic turmoil, when economies rely on debt markets to fund expenditures. During such periods, politicians prefer to draw on debt markets rather than requesting the aid of external actors because of the conditions attached to funds provided by external actors. That said, some actors are more willing to resort to external actors if they are able to extract resources without granting substantial concessions. This has been the case with Italy and Spain, which reap the benefits of the supply-side advantages implied by the hybrid model and shown in Figure 1. Too large to bail out, Italy and Spain extracted funds from the ECB with relatively few concessions. For small countries, without such supply-side advantages, extensive conditionality typically accompanies funds. Chapters 5, 6 & 7 explore the comparative dynamics of bond-market access for small and large economics in great depth.

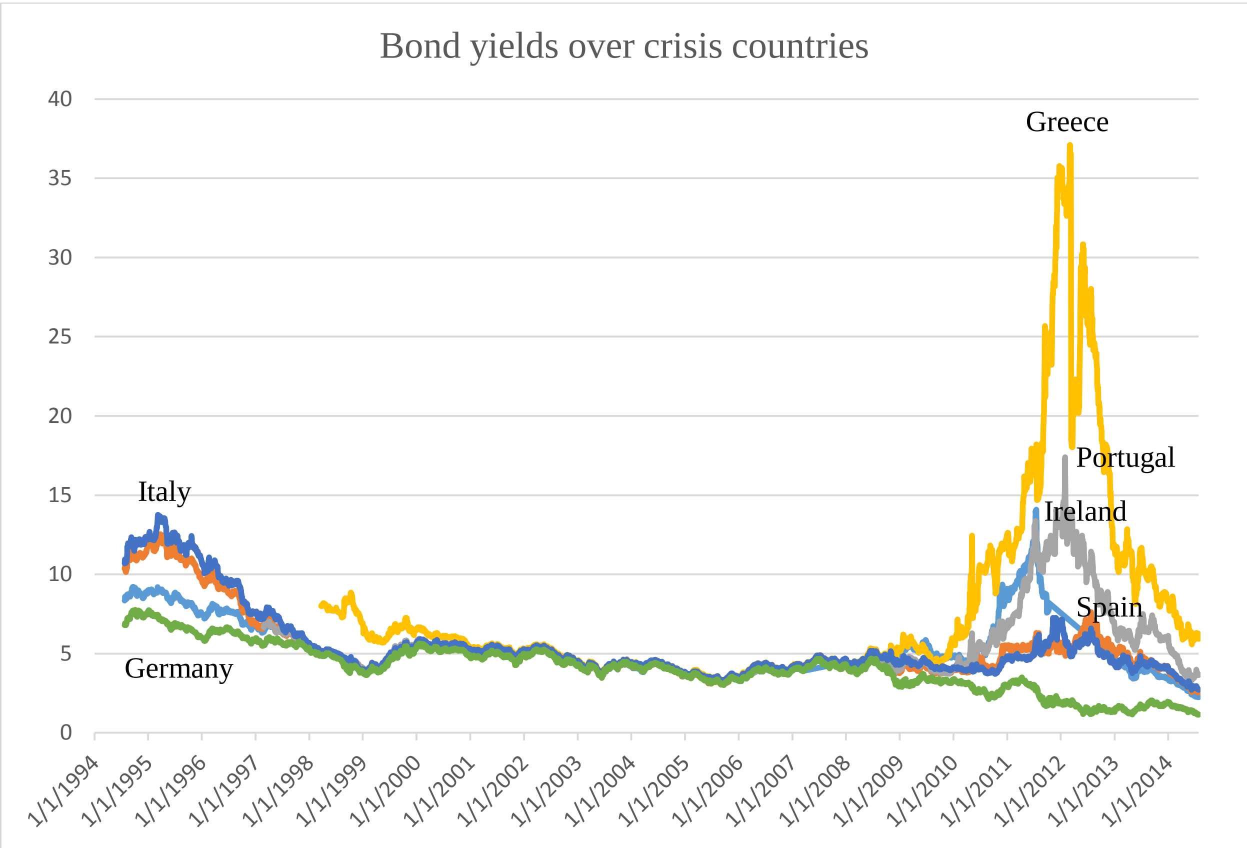

Figure 2. Bond yields over the crisis countries with German yields presented as a baseline. The vertical axis presents bond yields between 0 and 40 percent. The horizontal axis ranges from 2000 to 2014, although the study's sample only covers 2000 to 2013. County names are indicated near the country's maximum yield over the period. Each country's yield is color-coded: Germany (green); Greece (yellow); Ireland (light blue); Italy (dark blue); Portugal (gray); and Spain (red).

The creation of the European Union led to an unprecedented convergence of sovereign-debt yields among Eurozone economies. Figure 2 shows that yields on peripheral debt declined towards the German bund, as investors assumed that, in joining the Eurozone, countries in crisis would have access to, *inter alia*, Berlin's deep fiscal coffers. Nouriel Roubini, writing in the *Financial Times*, described the associated compression of bond yields as resulting from the "convergence trade."[1] Troublingly, the financial-market convergence occurred without either the fiscal or banking union required to transfer resources in response to a hypothetical crisis. Chapter 5 discusses how the lack of such a framework inhibited the initial Eurozone-wide responses to the 2008 financial crisis, exacerbated financial-market uncertainty, and ultimately both fueled and deepened the crisis. Importantly, the lack of either a fiscal or a banking union reflected a conscious political choice by the Eurozone's member countries. Such unions would have required the prospective transfer of resources that the wealthy, primarily Northern, core proved unwilling to countenance.

The tight convergence had three primary implications for the politics of adjustment policy. First, the convergence effectively eliminated country-specific risk in sovereign-debt markets. Between 2000 and the middle of 2008 the spread between the German bund and the yields of crisis countries was effectively zero. One way to interpret the contagion and turmoil that followed the 2008 financial crisis is the process through which bond markets began to price in country-specific risk. Second, before country-specific risk emerged on bond markets in mid-2008, the yield convergence allowed peripheral governments to sustainably finance large budget deficits. As a result, the dashed line in Figure 1 from external actors to domestic policy was not binding and thereby reduced the influence of external actors on domestic policy. Third, country-specific risk emerged gradually and haltingly. Bond traders did not begin to price country-specific risk efficiently overnight. In Figure 2, spreads increase in mid-2008 with the failure of Lehman Brothers, but crisis-country yields do not separate from one another until 2010. In the interim, bond market continued treat countries in groups, regardless of substantial differences in with respect to both politics and fiscal sustainability. It was this grouping that gave rise to, and

[1] Roubini, Nouriel and Arnab Das. "Medicine for Europe's sinking south." *Financial Times*. 3 February 2010.

encouraged, the misleading acronym of “PIIGS” to flourish. However, on the bond markets, this group appeared as an aggregate, homogenous phenomenon only briefly—roughly from the middle of 2008 through the beginning of 2009. After this period, significant spreads emerged, even though there were periods of significant and positive correlation (during the negotiations over the first and second Greek bailouts). In contrast to misleading and homogenizing analyses, the governments and economies in Portugal, Ireland, Italy, Greece, and Spain confronted problems substantially different from one another and possessed disparate sets of political tools. With a limited number of exceptions, these differences tended to be treated differently by lenders, particularly late in the crisis period, as reflected in the divergent movements of sovereign-debt yields. The degree to which the press reflected this divergence lagged behind the financial-market nuance.

A large academic literature explores the dynamics of bond yields in general and within the Eurozone in particular. Most of these studies seek to identify either the determinants of sovereign-bond spreads or how these determinants change over time. Ejsing & Lemke (2009) performs both of these tasks and finds that the value of credit default swaps (CDS on sovereign debt increase following the onset of the financial crisis.[2] The authors also find increased CDS sensitivity to fiscal policy in Eurozone countries following the onset of the financial crisis. Sgherri & Zoli (2009) identify a time-varying, common factor in Eurozone spreads.[3] The authors catalogue a number of distinct regimes, but their analysis is restricted between the creation of the Euro in January 1999 and April 2009. Bernoth & Erdogan (2010) model the time-varying

[2] Ejsing, Jacob, and Wolfgang Lemke. "The Janus-headed salvation: Sovereign and bank credit risk premia during 2008–2009." *Economics Letters* 110.1 (2011): 28-31.
[3] Sgherri, Silvia, and Edda Zoli. "Euro area sovereign risk during the crisis." *IMF Working Papers* (2009): 1-23.

common component explicitly and largely confirm the results of Sgherri & Zoli.[4] Bernoth & Erdogan advance the discussion of Sgherri & Zoli by including variables to explain country-level changes in bond yields. In addition to the common factor identified by previous studies, Bernoth & Erdogan finds that a country's level of debt explains variation in bond yields. As is the case with the common factor, however, the individual country-effect is time-varying.

In contrast to previous studies that analyze data through the first year of the financial crisis, at the latest, Chapter 4's analysis includes bond yields through the end of 2013. As in previous studies, the present chapter identifies a number of regimes in which bond yields displayed distinctive behavior. The present bond-yield analysis traces the post-accession convergence trade through the gradual emergence of country-specific risk following the financial crisis. The chapter identifies three distinct periods that differentiate behavior of bond markets: pre-accession; pre-crisis but post-accession; and post-crisis.

Country	Observations	Mean	SD	Min	Max
Germany	5191	4.096	1.499	1.146	7.755
Finland	4814	4.110	1.375	1.286	7.970
Netherlands	5166	4.243	1.402	1.339	7.874
France	5176	4.350	1.413	1.542	8.431
Belgium	5167	4.540	1.376	1.537	8.680
Spain	5172	5.291	2.021	2.541	12.559
Ireland	4678	5.346	1.802	2.244	14.079
Italy	5173	5.457	2.253	2.704	13.753
Portugal	4326	5.490	2.112	3.160	17.393
Greece	4237	7.654	6.021	3.230	37.101

Table 1. Summary statistics of Eurozone bond yields between 1994 and 2014. The first column indicates the relevant country; the second column indicates the number of observations available for a given country over the sample; the third column indicates the mean bond yields; the fourth column indicates the standard deviation of the bond yields; the fifth and sixth columns give the minimum and maximum bond yields over the sample, respectively.

Descriptive statistics

[4] Bernoth, Kerstin, and Burcu Erdogan. "Sovereign bond yield spreads: A time-varying coefficient approach." *Journal of International Money and Finance* 31.3 (2012): 639-656.

Table 1 summarizes bond-yield data from selected countries in the Eurozone. Data is taken from Bloomberg and includes all crisis countries in addition to all other Eurozone members for which data is available.[5] The data runs from 1994 to 2014. Particular dates of interest over this time include the creation of the Eurozone on 1 January 1999 and the failure of Lehman Brothers on 15 September 2008. The latter is used to mark the beginning of the financial crisis in Europe.

Table 1 reveals a number of important features of the bond-yield data. First, the time series for Greece, Ireland, and Portugal are noticeably shorter than for the remaining countries. Data collection began in February 1997 for Portugal and March 1998 for Greece. Irish debt, on the other hand, stopped trading between October 2011 and March 2013.[6] Second, and most relevant to the present analysis, the mean and standard deviation data divides the countries roughly into two categories. In the first, low-volatility category, which includes Germany, Finland, the Netherlands, France, and Belgium, bond yields are below 4.5% with standard deviations below 1.5. In the second, high-volatility category, which includes Spain, Ireland, Italy, Portugal, and Greece, bond yields are above 5% with standard deviations closer to and above two. Even in the high-volatility category, Greece is a relative outlier in both mean and standard deviation with an average bond yield of 7.7% and a standard deviation of six. The ranges similarly reflect these low- and high-volatility categories.

Regime analysis

Methodology

[5] Data on Slovakia was available but not included because it entered the Eurozone relatively late in the sample. Thus, Slovakia would introduce post-accession currency risk not present in any other sample countries. Whereas regression-based approaches enable controlling for Eurozone entry, factor analysis does not permit such flexibility.
[6] This is indicated by the straight line connecting the Irish series between October 2011 and March 2013.

Previous studies employ a variety of methods to analyze Eurozone bond yields. Most of these methods leverage the cross-section and time-series variation in extended financial time series. One set of studies employs regression frameworks to identify the determinants of bond-yield spreads. The other set of studies employs multivariate methods to characterize the interrelationship between bond yields. The present chapter discusses the former method but exclusively applies the latter. The former approach specifies models of bond yields as a function of macroeconomic fundamentals and fiscal characteristics. Haugh, Ollivarud & Turner (2009)[7] and Sgherri & Zoli (2009) fall into this category. The papers differ on the basis of the sample considered, but both identify significant effects of debt-burden on bond yields. The two papers emphasize the relative importance of credit to liquidity risk in spreads.[8] While there are important advantages to the approach taken in the first set of studies, they rely on an underdeveloped theoretical framework. While a fully specified, general equilibrium model for sovereign bond yields is unrealistic, it is unclear whether and how important political events such as elections and coalition conflicts influence bond yields, independent of the macroeconomic and fiscal characteristics already identified in the present studies.

While both papers note that the effects of fiscal and macroeconomic characteristics are time-varying, a second set of papers models the temporal dependence more explicitly. This second set of studies searches for more general trends in the data. In the process, these papers avoid the identification concerns implied by the general-equilibrium criticism of the first set. In doing so, however, the second set forgoes the opportunity to identify the effect of discrete events

[7] Haugh, David, Patrice Ollivaud, and David Turner. "What Drives Sovereign Risk Premiums?" *OECD Working Paper*. (2009).

[8] Credit risk is the risk of default based on insolvency. Liquidity is the risk that arises from default based on cash flow and generally arises because of mismatch in the term (i.e., time horizon) of assets and liabilities. An example of liquidity risk involves the long-term, relatively illiquid assets held by banks compared with their relatively short-term liabilities, which can be as short-term as overnight paper.

on bond spreads. Bernoth & Erdogan (2010) employs a semiparametric, time-varying coefficient model to formalize the regime analysis. The authors find that the effects of fiscal characteristics on bond yields vary across time. Geyer, Kossmeier & Pichler (2004) identifies two latent factors that explain the majority of variation in Eurozone spreads.[9] Because of its publication date, however, the study does not include data from the 2008 financial crisis. Ejsing & Lemke (2009) proxy for a common risk factor using the iTraxx index of non-financial CDS premia. The iTraxx index is a financial index of credit default swaps. Their results are robust to employing a common factor constructed using factor analysis, the approach adopted in the present chapter. Ejsing & Lemke find that the amount of variation explained by the common factor varies over time, with a clear structural break at the beginning of the 2008 financial crisis. The present paper follows Ejsing & Lemke in identifying a common risk factor. The present chapter, however, departs from past literature in several main ways. First, Chapter 4 extends the sample of past studies, which terminate, at the latest, after the first year of the financial crisis. Second, the chapter employs factor analysis. Third, the chapter emphasizes cross-section, as well as time-series, variation in the interrelationship of bond yields. Factor analysis provides a tractable method to study both types of variation.

Factor analysis reduces the dimensionality of large datasets. Through the reduction, factor analysis identifies common elements and distinguishes features across series. The following discussion draws heavily on Tsay (2010).[10] Suppose a sample contains observed bond yields, Y_{ct}, of C countries over T time periods. A general factor model then assumes the following form:

[9] Geyer, Alois, Stephan Kossmeier, and Stefan Pichler. "Measuring systematic risk in EMU government yield spreads." *Review of Finance* 8.2 (2004): 171-197.
[10] Tsay, Ruey S. *Analysis of financial time series*. Vol. 543. John Wiley & Sons, 2010.

$$Y_{ct} = \alpha_c + \beta_{c1} * f_{1t} + \ldots + \beta_{cm} * f_{mt} + \epsilon_{ct},\ c=1,\ldots,C;\ t=1,\ldots,T, \qquad \textit{(Equation 1)}$$

where α_c is a country-specific constant that does not vary over time; $\{f_{jt}|j=1,\ldots,m\}$ are m common factors; β_{cj} is the factor loading for country c on the jth factor, and ϵ_{ct} is the specific factor of country c at time t. The parameters of primary theoretical interest are the coefficients on the common factors. Also important is the proportion of bond-yield variation explained by each common factor. There is not a "correct" number of common factors. In general, Chapter 4 presents the first three factors but analyzes only the first two. Typically, the first two factors explain more than 95% of the observed variation in bond yields. The next section applies factor analysis to the aggregated data; subsections perform factor analysis on particular subsamples with an eye towards characterizing different regimes of bond-yield behavior.

Aggregate

Table 1's summary statistics mask important variation, both in the cross-section and time series. Factor analysis is first applied to the aggregate data before being applied to different subsamples of data. In each of the factor analyses, tables present the factor loadings for the first three factors, except in Table 6, for which only two factors are presented due to data limitations. In the context of Equation 1, the first three factors correspond to β_{c1}, β_{c2}, and β_{c3}, respectively, where c indicates a particular country. The bottom two rows of each table indicate the proportion of variance explained and eigenvalues for each factor.[11] These measures indicate the relative importance of the various factors.

Country	Factor 1	Factor 2	Factor 3
Belgium	0.994	-0.019	0.070
Finland	0.965	-0.249	0.058
France	0.975	-0.216	0.025

[11] Like the proportion of variance explained, the eigenvalue provides a measure of each factor's relative importance. The two expressions are mathematically related. The proportion of variance explained by a given factors is equal to the factor's eigenvalue divided by the number of variables, which in the present context, correspond to the number of countries in a particular subsample.

Germany	0.943	-0.305	0.073
Greece	-0.171	0.943	-0.006
Ireland	0.316	0.827	0.332
Italy	0.875	0.387	-0.259
Netherlands	0.965	-0.255	0.048
Portugal	0.132	0.966	-0.011
Spain	0.778	0.562	-0.183
Proportion	**0.640**	**0.334**	**0.023**
Eigenvalue	**6.209**	**3.240**	**0.227**

Table 2. Factor analysis of Eurozone bond yields between 1994 and 2014. The first column indicates the relevant country. The second, third, and fourth columns indicate the factor loadings. The two bolded rows at the bottom of the table indicate the proportion of variance explained by a given factor and the factor's eigenvalue.

Table 2 displays the results of factor analysis on the aggregate data, spanning all countries in the dataset from 1994 to 2014. The results reinforce the intuition with respect to high- and low-volatility categories implied by Table 1's summary statistics, with two important caveats. The first factor indicates the degree to which Greece is an outlier. First, explaining nearly two-third of the variation in yields, the first factor indicates the exceptional position of Greece, whose negative loading contrast with the positive loading on each remaining country. While Portugal's and Ireland's loadings are relatively close to Greece's, the first factor can be interpreted as the extent to which countries are not like Greece. Second, with respect to the first factor, Italy and Spain appear more similar to the low-volatility countries than those in the high-volatility countries. However, underscoring Table 1's key stylized fact, the second factor, which explains approximately a third of the variation in the dataset, divides the countries into the same low- and high-volatility groups found in Table 1.

To examine variation over time, subsequent analysis divides the sample into three sub-samples. First, Table 3 presents the results of factor analysis on bond-yield data prior to the creation of the Euro, on 1 January 1999; this subsample is referred to as the pre-accession subsample. Next, Table 4 presents the results of factor analysis on bond yields after the creation of the Euro (post-accession) but before the beginning of the financial crisis (pre-crisis), dated here as the failure of Lehman on 15 September 2008; this subsample is referred to as the post-accession, pre-crisis subsample. Finally, Table 5 presents the results of factor analysis on bond yields after the onset of the financial crisis; this subsample is referred to as the post-crisis subsample.

The pre-accession subsample

Country	Factor 1	Factor 2	Factor 3
Belgium	0.990	-0.088	-0.062
France	0.994	-0.006	-0.075
Germany	0.985	-0.160	0.051
Ireland	0.993	0.002	0.102
Italy	0.979	0.199	0.016
Netherlands	0.991	-0.128	-0.015
Spain	0.981	0.185	-0.016
Proportion	**0.980**	**0.018**	**0.003**
Eigenvalue	**6.826**	**0.123**	**0.023**

Table 3. Factor analysis of Eurozone bond yields between 1994 and 1 January 1999, the creation of the Euro. See Table 2 for further explanation.

Table 3 presents the factor analysis of the pre-accession subsample. Finland, Greece, and Portugal are excluded from the analysis in Table 3, because data collection on these countries did not begin until after the subsample. Table 3 introduces nuance to the intuition implied by Table 1. The second factor differentiates between groups. However, it explains only 2% of the variation in bond yield data. The overwhelming importance of Factor 1 indicates the successful progress on economic convergence that preceded the adoption of the Euro. The relative dominance of the first factor also reflects the exclusion of Greece and Portugal, the two countries identified as most distinctive in Table 2's aggregate analysis. Notwithstanding the exclusion of Greece and Portugal, the tight relationship of yields is surprising given that the subsample includes country-specific currency risk, which was not formally limited until the introduction of the Euro. The tight relationship between yields underscores the powerful role of expectations in financial markets, as actors anticipated the consequences of the Euro's creation and drove spreads near zero prior to the formal introduction of the currency.

The post-accession, pre-crisis subsample

Country	Factor 1	Factor 2	Factor 3
Belgium	0.999	-0.013	-0.025
Finland	0.998	-0.007	0.042
France	0.999	-0.044	0.023
Germany	0.994	-0.073	0.075
Greece	0.869	0.332	0.006
Ireland	0.995	-0.032	-0.002
Italy	0.994	-0.068	-0.066
Netherlands	0.999	-0.037	0.025
Portugal	0.998	-0.014	-0.051
Spain	0.999	-0.021	-0.026
Proportion	**0.986**	**0.013**	**0.002**
Eigenvalue	**9.703**	**0.125**	**0.017**

Table 4. Factor analysis of Eurozone bond yields between 1 January 1999, the creation of the Euro, and 15 September 2008, the onset of the financial crisis. See Table 2 for further explanation.

Table 4 analyzes the span of time after the formation of the Euro (post-accession) but before the financial crisis (pre-crisis). It includes those countries, Finland, Greece, and Portugal, excluded from Table 3's analysis. Following the convergence process that accompanied accession to the single currency, the first factor explains 97% of the variation in debt yields. Interestingly, this suggests that the formal introduction of the Euro did little to push spreads together. The financial-market implications had been internalized in the years prior to the Euro's introduction. The second factor explains a similarly small proportion of variation as in the pre-accession subsample. The second factor's effect, however, is dominated by Greece, which had been excluded from Table 3's analysis. This provides empirical corroboration of Greece's outlier mean and standard deviation in Table 1. Moreover, it shows that prior to the crisis, the so-called "PIIGS"—referred to here as crisis countries—were not all treated similarly. Bond yields in Portugal, Ireland, Italy, and Spain more resembled the low-volatility countries of Northern

Europe than the already precarious Greek position. In the aftermath of the financial crisis, it became conventional to refer to these as behaviorally, economically, and financially similar. Table 4 underscores how these similarities, at least from the perspective of financial markets, were not present prior to the financial crisis. The similarity in financial position among the crisis countries emerged only following the onset of the crisis, as a comparison of Tables 4 & 5 indicates.

The post-crisis subsample and the emergence of country-specific risk

Country	Factor 1	Factor 2	Factor 3
Belgium	0.981	-0.118	0.033
Finland	0.873	-0.481	0.029
France	0.910	-0.410	0.003
Germany	0.867	-0.476	0.082
Greece	0.215	0.935	0.114
Ireland	0.738	0.552	0.299
Italy	0.785	0.456	-0.370
Netherlands	0.875	-0.480	-0.008
Portugal	0.372	0.902	0.053
Spain	0.672	0.654	-0.147
Proportion	**0.605**	**0.361**	**0.028**
Eigenvalue	**5.866**	**3.498**	**0.272**

Table 5. Factor analysis of Eurozone bond yields following 15 September 2008, the onset of the financial crisis. See Table 2 for further explanation.

Table 5 analyzes the span of time after the financial crisis (post-crisis), dated as the failure of Lehman Brothers on 15 September 2008. Table 5 reveals a number of important characteristics of the post-crisis period. In contrast to the previous two tables, the second factor in Table 5 explains a significant proportion of variation. In Table 2, which aggregates all data over time, the second factor explains a third of the variation in bond-yield data. In Tables 4 & 5, the second factors explain a trivial proportion of variation. Thus, a comparison of Tables 3, 4 & 5 indicates that the significance of the second factor, which can be interpreted as the emergence of country-specific risk, is explained entirely by post-crisis variation in bond yields. After the financial crisis, the second factor explains more than a third of the variation, while the first factor explains less than two-thirds. Compared with the data from the pre-crisis periods, the first and second factors from the post-crisis period indicate the divergence of economic fortunes in contrast to the homogeneity implied by the pervasive positive correlations displayed in Tables 2, 3 & 4. As in the post-accession, pre-crisis subsample, the second factor in the post-crisis subsample distinguishes low- from high-volatility countries, with similarly signed weightings on Greece, Ireland, Italy, Portugal, and Spain. However, the loadings on the first factor in the post-crisis subsample hint at more subtle variation within the set of crisis countries. The loadings on Greece and Portugal are noticeably lower than those on all other countries, both those in low- and high-volatility categories. Table 6 delves further into this variation.

Post-accession, pre-crisis			**Post-crisis**		
Country	**Factor 1**	**Factor 2**	**Country**	**Factor 1**	**Factor 2**
Greece	0.874	0.247	Greece	0.868	-0.406
Ireland	0.993	-0.051	Ireland	0.852	0.079
Italy	0.994	-0.106	Italy	0.823	0.375
Portugal	0.998	-0.039	Portugal	0.943	-0.250
Spain	0.999	-0.021	Spain	0.931	0.228
Proportion	**0.985**	**0.016**	**Proportion**	**0.919**	**0.100**
Eigenvalue	**4.729**	**0.077**	**Eigenvalue**	**3.913**	**0.426**

Table 6. Factor analysis of Eurozone bond yields in subsets of risis countries. The left-hand-side of the figure displays post-accession, pre-crisis results. The right-hand-side of the figure displays post-crisis results. The column and rows correspond on both the right- and left-hand-sides correspond to those in Table 2; see Table 2 for further explanation.

Table 6 analyzes the subset of high-volatility countries. The left-hand-side displays post-accession, pre-crisis results; the right-hand-side displays post-crisis results. The analysis reveals a number of important characteristics of bond yields in high-volatility countries. First, the first factor explains the majority of variation, as in all the previous tables. Moreover, the convergence factor is stronger before the crisis than after the crisis when financial markets began to price in country-specific credit risk. Second, as in previous tables, Greece is clearly an outlier, particularly in the pre-crisis period, as underscored by Greece's positive second factor loading on the left-hand-side of the table. Interestingly, the right-hand-side of the table indicates that Greece is less of an outlier once the crisis begins. This likely reflects the effects of contagion. As can be seen in Figure 2, around the time of each successive Greek bailout, spreads on Irish and Portuguese debt increased. The effect is particularly salient with respect to Portugal. In addition, the second factor in the post-crisis subsample also groups Ireland, Italy, and Spain together, highlighting the similarity of their treatment by bond markets following the financial crisis. Ireland's loading, however, is substantially lower than the loadings on both Italy and Spain. While still closer to the loadings on Italy and Spain than those on Portugal and Greece, Ireland's intermediate value indicates that Ireland's treatment by bond markets combined elements of both groups of countries. This dynamic is clear in Figure 2, with Ireland's close co-movement with Portugal and Greece until the middle of 2011. Towards the end of 2011 and prior to the second Greek bailout, Ireland permanently separated itself from the bond yield trajectories of both Greece and Portugal. Chapters 6 & 7 explore the reasons for the observed separation.

Conclusions and theoretical implications

Tables 1 through 6 offer an enormous amount of information related to the movements in bond yields before, during, and following the financial crisis. While the empirical and theoretical implications of these results are numerous, the differences between low- and high-volatility countries are particularly important for the present analysis. There are, broadly speaking, two categories of countries, termed low- and high-volatility countries. These categories map onto the categories of non-crisis and crisis countries. The remaining three points indicate problems that emerge from viewing the crisis countries as a cohesive category and as fundamentally distinct from the subset of low-volatility countries. First, as the first factors—which can be interpreted as the convergence factor—from Tables 2 through 6 indicate, the dominant economic trend is one of convergence across the entire Eurozone, not within either the low- or high-volatility countries. While the importance of the convergence factor decreased following the financial crisis, it still explained nearly two-thirds of the variation in bond yields in the post-crisis subsample. Second, the results overall, and Table 6 in particular, confirm the heterogeneity of bond yields within the high-volatility countries. Not all crisis-country bond yields exhibited identical behavior. Greek and Portuguese yields moved more closely with one another than did the yields of other countries. Third, there is clear heterogeneity not only within categories of countries but also over time. The notion that high-volatility countries have exhibited consistently different bond market behavior from the mid-1990's through the financial crisis is not true. While Greece has always been an outlier, the remaining crisis countries resembled the low-volatility countries prior to the financial crisis. Only after the failure of Lehman and a number of related events did bond markets begin to treat these two sets of countries differently.

Returning to the hybrid model's schematic displayed in Figure 1, the results in Chapter 4 have important implications for the relationship between external actors and fiscal-policy outcomes. Bond yields provide an indirect measure of the demand for financial resources from external actors. When bond yields are high, domestic actors are more likely to resort to external actors for funds and submit to the concomitant conditionality. However, the ability of yields to expose individual countries and governments to pressure from external actors requires that financial markets price in country-specific risk. In the pre-crisis periods, as the convergence trade drove bond spreads across the Eurozone to zero, country-specific credit risk disappeared. Thus, in addition to instantiating widespread moral hazard, the convergence dynamics dramatically reduced the influence of external actors in domestic policymaking during the pre-crisis period.[12] However, with the emergence of country-specific credit risk in the post-crisis period, the influence of external actors increased dramatically. Chapter 5 explores the role played by external actors throughout the sample in greater depth. Moreover, throughout Chapter 5's analysis, it is important to bear in mind the financial-market dynamics characterized by Chapter 4.

[12] In a sense, the convergence trade can be interpreted as reducing the democratic deficit within the European Union. By reducing the influence of external actors in domestic policymaking, the convergence trade shifted the balance of power between Brussels and member-state capitals. Problematically, however, the reduction is democratic deficit gained in the pre-crisis period was predicated upon a fundamentally unsustainable macroeconomic context, shaped by a currency union with neither banking nor fiscal components.

Chapter 5: External actors and fiscal policy

Introduction

Chapter 5 is divided into three sections. The first section presents an overview of the relevant external actors in the context of the Eurozone and the 2008 financial crisis. The second section discusses the various sources of funding available to governments, describes the particular paths of influence between external actors and governments, and describes the universe of relevant actions of external actors. The third and final section concludes with a series of case studies, which illustrate important features of the relationship between external actors and fiscal policy.

Institutional overview

The European Central Bank

The Troika is made up of the European Central Bank (ECB), the European Commission (EC), and the International Monetary Fund (IMF). Ostensibly, the three act in concert, each drawing on different organizational strengths in order to return troubled countries to some combination of financial and fiscal health. The strength of both the ECB and IMF is technocratic, with the ECB's knowledge shaded towards financial markets and the IMF's towards fiscal policy and debt sustainability.[1] The two organizations differ in their constituent geographic areas of responsibility. The ECB is responsible for the monetary policy of the Eurozone, with some marginal responsibility for non-Euro countries in the EU. The ECB's Executive Board (EB), consisting of a President, a Vice-President, and four other members, includes members appointed by member states in consultation with the European Parliament and the ECB's Governing

[1] The conditions for granting aid reflect these expertise. In the appendix to Chapter 5, Table A1 presents the conditions under which the various external organizations, according to their charters, can provide financial aid.

Council (GC) for eight-year, non-renewable terms. The GC includes the governors of the national central banks of Euro-area governments and the members of the Executive Board. The EB implements the policy formulated by the GC.[2]

Because of the ECB's eight-year terms, the ECB's leadership remained relatively constant, following the 2008 financial crisis, particularly when juxtaposed with the national parliaments that cycled through multiple governments. France's Jean-Claude Trichet served as the ECB President through 2011, when Italy's Mario Draghi assumed the helm. Some observers hoped that Draghi's Southern European origin would influence policies adopted as the head of the ECB. And while Draghi experimented with heterodox policies, particularly in the context of long-term refinancing operations (LTRO's), the ECB's political independence and Draghi's conservative track record as an Italian central banker proved far more influential in shaping the Bank's policies.

In contrast to the dual mandate—for full-employment and price stability—of the US Federal Reserve, the ECB's sole objective is to maintain price stability. The ECB defines price stability as the "year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the Euro area below 2%."[3] In conducting monetary policy and in coordinating fiscal-policy responses, the European Central Bank is primarily concerned, in the near-term, about liquidity. Unlike the IMF, which requires solvency as a condition for the disbursement of funds, the ECB is more willing to grant funds in order to help a government regain solvency. In constructing post-crisis policy, the ECB reflects the preferences of the Northern European economies, which contribute the majority of bailout funds. Thus, the ECB favors expenditure-centric austerity, with

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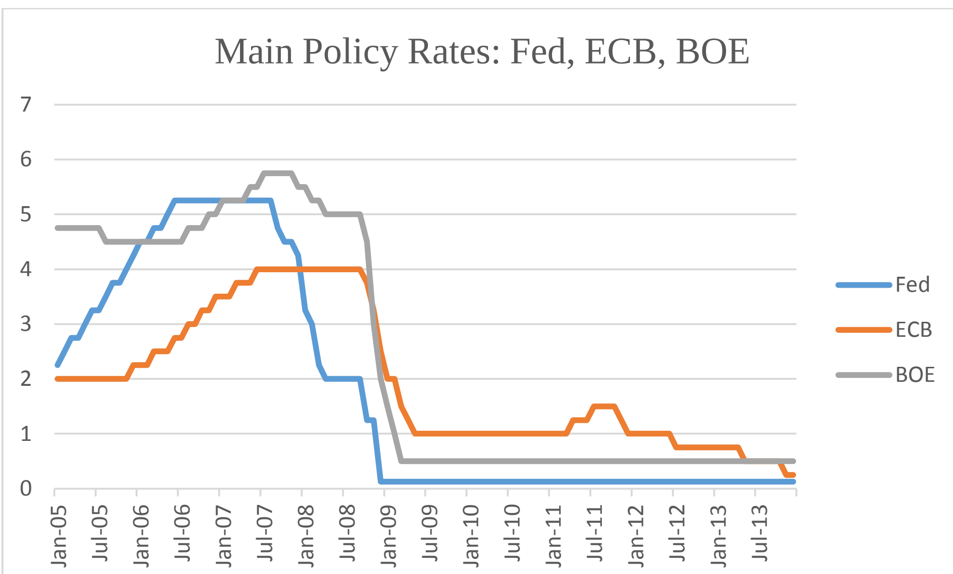
[2] Hodson, Dermot. "Economic and monetary union." *Policy-Making in the European Union, 6th ed.(Oxford and New York: Oxford University Press 2010) pp* (2010): 159-165.
[3] "The definition of price stability." *European Central* Bank. Web. <https://www.ecb.europa.eu/mopo/strategy/pricestab/html/index.en.html>.

the majority of adjustment coming from decreasing public expenditure, rather than increased taxation.

When combined with the Eurozone's set-up as a currency union with neither fiscal nor banking components, the ECB's single mandate leaves the Eurozone without an area-wide, institutional response to sharp changes in either the financial or real economies. This set-up means that, in the face of financial or fiscal crisis, responsibility for response resides with national governments rather than a supranational authority.[4] This complicated the response to the 2008 financial crisis when national governments adopted individual responses without regard for neighbors' policies.[5] The European Financial Stability Fund (EFSF) was established only after the May 2010 bailout of Greece,[6] when the EU policymakers recognized the need for an institution that could draw on collective resources of EU governments without facing the crippling collective action problem of coordinating the actions of several domestic governments, each with a distinct set of distributional preferences.



[4] Hodson (2010), p. 165.
[5] Dinan, Desmond. *Ever Closer Union*, 4th edition. Boulder, Lynne Rienner Publishers, 2010, and Basingstoke, Palgrave Macmillan, 2010: p.158.
[6] "European financial stabilization mechanism." *EUR-Lex*, 11 May 2010. Web. <http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1439818628650&uri=URISERV:ec0009>.

Figure 1. Main monetary policy rates in US, Eurozone, and the United Kingdom. These rates are the federal funds target rate, the main refinancing operations bid rate, and the official Bank rate, respectively. Data taken from the Fed, ECB, and BOE, respectively.

Initially, in the crisis period, the ECB adhered closely to the single mandate. Policies adopted later in the crisis, including extensive bond purchases and long-term refinancing operations—detailed in Table 1—are more difficult to justify within the context of a strict single mandate. Notwithstanding such policy innovations, by comparison, the ECB remained far more detached from the real economy than the US Federal Reserve. This can be seen in Figure 1, at the onset of the crisis,[7] when the ECB took months longer than either the Fed or the BOE to reach its rate-floor. Moreover, the ECB's policy rate-floor remained a full point higher than the Fed's and a half point higher than the BOE's. Finally, at the first sign of pick-up in the real economy, over fears of pent-up inflation and under the relatively conservative governorship of Jean-Claude Trichet, the ECB raised rates in early 2011. The ECB's monetary policy was thus more conservative to the Fed's, governed by a dual mandate, and the BOE's, governed by a single mandate. Notably, divergence between ECB/BOE monetary policies may also reflect the wider scope, both geographic and financial, governed by the former. In addition, the ECB is alone among major central banks in governing a currency area without concomitant banking and fiscal unions. This places the ECB in an awkward position, when banking or fiscal crises threaten price stability, the ECB's charter-determined province. The uncertainty engendered by the ECB's mismatch of mandate and authority played an important role in both deepening and propagating the crisis.

The International Monetary Fund

[7] Lehman's failure on 15 September 2008 is used to mark the beginning of the financial crisis. For further discussion, see Chapter 2.

In contrast to the EC and the ECB, the IMF possesses a much larger geographic portfolio, including all countries in the EU, and extending throughout the world. Indeed, as of 2012, 188 countries belonged to the IMF.[8] The IMF has a lending portfolio of more than $300 billion, which it can lend to member-countries facing balance-of-payment deficits.[9] Importantly, as Table A1 shows, the IMF lends only to countries facing liquidity, as opposed to solvency, problems.[10] Prior to the receipt of IMF funds, a country must demonstrate fiscal solvency. This insistence has led to some friction between the IMF and EC/ECB, when the IMF supports either restructuring of debt burden or additional, credible reform in crisis environments when the EC/ECB prefer the immediate disbursement of funds. In addition, similar to the ECB, the IMF advocates expenditure-centric austerity, although the preference arises from a technocratic belief more than a preponderance of power within the Fund belonging to an individual country or set of countries that advocates such policy. The preferences of the IMF are not set in stone. Instead, as technocratic beliefs, they are susceptible to insights provided by new data. As is explored in subsequent sections, such flexibility played an important role in shaping the IMF's crisis over the sample.

Two bodies dominate IMF policymaking: the Board of Governors (BOG) and the Executive Board.[11] The BOG is comprised of a single member appointed by each member state. In addition, the BOG only meets once per year. Thus, most decisions throughout the year fall into the hands of the Executive Board, which consists of 24 executive directors appointed by

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[8] "List of Members." *International Monetary* Fund, 13 June 2012. Web. <https://www.imf.org/external/np/sec/memdir/ memdate.htm>.

[9] Oatley, Thomas H. *International political economy*. Boston: Longman, 2012: p. 310.

[10] This is related to the distinction between credit and liquidity risk discussed in Chapter 4. Solvency risk reflects a mismatch in value between assets and liabilities. Liquidity risk reflects cash-flow risk. Importantly, in many cases, the difference is one of degree, rather than kind. Solvency risk can be viewed as liquidity risk with illiquid assets. This is particularly the case in context of well-developed financial markets in the context of a crisis where asset values drop sharply as a result of a collective sell-off.

[11] Note that, though the two bodies share the same name, this is not the same Board as the ECB's Executive Board.

member governments. Eight countries[12] appoint directors directly; the remaining 16 executive directors represent groups of countries. As the Executive Board's make-up implies and, in contrast to the ostensibly egalitarian set-up of the BOG, IMF policy is primarily formulated by the world's largest and/or politically most important economies. This asymmetry is further reinforced by the Fund's weighted voting scheme that accords votes on the basis of financial contributions to the fund. Thus, the US controls 17% of the Fund's votes; while Palau, the smallest member country in terms of contribution, controls 0.01% of the Fund's votes.[13]

Early in the crisis period, organizational differences between the Europe-centric institutions (EC/ECB) and the IMF did not create problems. In May 2010, however, non-European IMF member countries voiced concerns about the lenient treatment granted to European states relative to the past IMF-brokered deals in Latin America and East Asia. [14] Despite such frustration, no state sought to veto the aid initial aid package extended to Greece. Moreover, until relatively late in negotiations over the first Greek bailout, the EC and ECB were opposed to the involvement of the IMF. The Europe-centric institutions feared the precedent that would be set by transferring fiscal sovereignty outside of the Eurozone. Financial-market observers, however, welcomed the IMF's involvement, largely because of the organization's technocratic expertise and experience in orchestrating fiscal adjustments.[15] The differing constituencies also help to explain the organizations' different preferences over bondholder losses. The IMF consistently advocates the restructuring of debt as a mean to improve debt sustainability. Indeed, the IMF pushed for expansive private-sector involvement in negotiating

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[12] China, France, Germany, Great Britain, Japan, United States, Russia, and Saudi Arabia

[13] More information on the IMF can be found in Oatley (2011), pp. 310-2.

[14] Brown, Kevin, Oliver, Christian and Tim Johnston. "Asia irked by IMF 'leniency' to Greece." *Financial Times*. 1 May 2010.

[15] Barber, Tony. "IMF's role in rescue finally wins backing of reluctant states." *Financial Times* 4 May 2010.

Greece's second bailout. The EC/ECB, on the other hand, reacted strongly against private-sector involvement with large portions of Greek debt held by Eurozone banks, which fell under the ECB's regulatory purview.[16]

Both the ECB and IMF are hierarchical organizations dominated largely by single individuals. Policy change with respect to either typically accompanies changes in leadership. Whereas Draghi's election as President of the ECB signaled policy changes, albeit short of a monetary-policy regime shift, leadership change in the IMF coincided with increased preference heterogeneity within the Troika. This was apparent in the negotiations over the second Greek bailout, in which the IMF's increasingly strident position accompanied a change in leadership, with Christine Lagarde's taking over as Managing Director in July 2011.[17]

The European Commission

Because of their hierarchical organizations, the ECB and the IMF are less hampered by the collective action problems that confront the European Commission, which is constituted by a single commissioner from each member-country, appointed for five-year terms. While a single president is elected from among these commissioners, the president's role is sharply constrained by the need to maintain consensus within the Commission.[18] Presidents, like Commissioners, are elected for five-year terms. Beginning in 2004, and for most of the crisis period, Jose Manuel Barroso, Portugal's former Prime Minister, served as the Commission's President. Although outside the scope of the present study, in July 2014, Jean-Claude Juncker, Luxembourg's former Prime Minister, was elected as the Commission's President. Each Commissioner has a separate

[16] Spiegel, Peter. "Merkel warned on bail-out impasse." *Financial Times*. 15 July 2011.
[17] Through the early part of the crisis, French politician Dominque Strauss-Khan served as the Managing Director of the IMF. In July 2011, following revelations of sexual misconduct by Strauss-Khan, Christine Lagarde took over as Managing Director.
[18] Gallagher, Michael, Michael Laver, and Peter Mair. *Representative government in modern Europe*. McGraw-Hill, 2011: p. 122.

policy portfolio. Most relevant to the politics of fiscal policy, the Economic and Financial Affairs Portfolio has been particularly controversial since the onset of the financial crisis. It is this individual, more than any other within the EC, who is identified with the policy conditionality required by the Troika. Between 2004 and 2010, Spain's Joaquin Almunia served in the position, followed by Finland's Olli Rehn between 2010 and 2014. Latvia's Valdis Dombrovskis began his term as Commissioner in 2014. Both the EC President and the Commissioner for Economic and Financial Affairs are positions contested between European factions. Olli Rehn, in particular, was viewed as the face of Northern European-imposed austerity on struggling Southern economies. The shift from Almunia to Rehn in 2010 was thus seen as a victory for the pro-austerity camp, as was the shift from Barroso to Juncker as the Commission's President in 2014. Nationality, however, is not an entirely reliable indicator of preference over fiscal policy. In contrast to the fears of Northern countries, the EC oversaw extensive austerity conditionality with Portugal's Barroso at its helm; similarly, at the ECB, Italy's Draghi continued to pressure Southern economies to implement reforms after he replaced France's Jean-Claude Trichet in 2011.

While the IMF is dominated by those countries that provide the majority of funds and the ECB is dominated by Northern economies (in particular, Germany), the EC is the only institutional member of the Troika, in which Southern countries are distinctly represented. This increases the democratic legitimacy of the Troika and also establishes a potential, and crucial, veto point for Southern economies which have limited representation elsewhere. As Table A1 suggests, this produces a different preference structure in the EC compared with that in either of the Troika's other two institutions. The EC's preferences are driven by the preferences of member countries. The representation provided to Southern economies was mitigated by the role of Northern representatives in key EC posts during the financial crisis (e.g., Commissioner for Economic and Monetary Affairs). In addition, the large number of Commissioners, each from a different country and grouped into a wide set of party families, makes concerted action difficult. As originally drafted, the Treaty of Lisbon would have ameliorated the collective action problem facing the EC by reducing the number of Commissioners form 27 to 18. *Inter alia*, fearing loss of representation, Irish representatives lobbied against the Lisbon Treaty, leading to its defeat in the June 2008 popular referendum.[19] The version of the Treaty that eventually passed maintained the number of Commissioners at 27, leaving the collective action problem facing the EC unaddressed. Because of the collective-action problem facing the EC, representatives from the ECB and IMF exercise decisive authority in Troika negotiations; in this sense, the EC functions most effectively as a veto point, rather than as an institution with a consistent and coherent agenda.

Responding to financial crisis

Anatomy of the crisis-response framework

The Troika is not mentioned in the founding charters of the European Union; nor is it mentioned in subsequent treaties. The Troika emerged, as an informal institution, in response to the financial crisis. The funding institutions employed by the Troika, which entered the colloquial lexicon following the bailouts of Greece and other Eurozone members, did not exist until after the Greek bailout in May 2010. The European Financial Stability Fund (EFSF) was established in June 2010 in response to the financial crisis. The lack of an institution to provide a fiscal stopgap, let alone an extended response, in the context of the financial crisis reflected the prior decision to establish the Eurozone as a monetary union without a fiscal union. In this

[19] Gallagher, Laver & Mair (2011), p. 123.

context, coordinating a fiscal response proved difficult for member countries. And the haphazard amalgamation of institutions following the financial crisis reflected the prior structural decisions made by Eurozone policymakers. At its inception in June 2010, the EFSF had a lending capacity of €440 billion, an additional €60 billion available from the European Financial Stabilization Mechanism (EFSM), and €250 billion from the IMF. [20] Combined, these produced a lending capacity of €750 billion. Importantly, the EU and the IMF did not pool funds, and the members of the Troika remained institutionally distinct. Thus, in principle, a Troika-led bailout could proceed, as it did with respect to Spain in June 2012, with funds provided by the EC/ECB but not the IMF. In March 2011, with bailouts underway in Greece and Ireland, Eurozone leaders expanded the lending capacity of the EFSF and agreed to create a permanent rescue mechanism, the European Stability Mechanism (ESM), which came into operation in October 2012. Amending Article 136 of the Treaty on the Function of the European Union, the text that produced the ESM reinforced the conditionality favored by the Northern constituency.[21] The ESM's lending capacity of €500 billion, matched that of the EFSM and the EFSM combined. The EFSF and ESM operated concurrently between October 2012 and June 2013, when the EFSF ceased extending loans. The EFSF will remain in operation until all outstanding loans have been repaid.[22] Once again, however, the ESM remained institutionally, and financially, independent of the IMF.

[20] "About EFSF." *European Financial Stability Facility*. Web. <http://www.efsf.europa.eu/about/index.htm> & "European Financial Stability Facility." *European Financial Stability Facility*. Web. <http://www.efsf.europa.eu/attachments/faq_en.pdf>.

[21] The full text of the ESM amendment reads: "The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality." For an analysis of how the amendment fits into the wider Treaty on the Functioning of the European Union, see De Witte, Bruno. "The European Treaty Amendment for the Creation of a Financial Stability Mechanism." (2011).

[22] "About us." *European Stability Mechanism*. Web. <http://www.esm.europa.eu/about/index.htm>.

The evolution of bailout institutions illustrates two important features of the supranational response to the financial crisis. These features reflect the institutional distinctness of Troika members, the piecemeal construction of the crisis-response institutional framework, and the manifest cleavages in preferences between national constituencies over institutional design and powers. First, as noted in the discussion of the EFSF, the ESM, and the IMF, the major actors within the Troika remained institutionally distinct, even within the subscribed context of bailouts. The ESM and the IMF both drew on funds from the EU member states, but each organization operated independently in response to financial crises. Early in the crisis, this presented less of a problem than later, when preference heterogeneity emerged within the IMF, the ECB, and EC.

Second, the institutional response was, and continues to be, ad hoc and piecemeal. The cleavages that characterized Troika policy throughout the financial crisis emerged in the prior debate over institutional form and powers. The European Monetary Union is first and foremost, what its name implies, a monetary union. Without a pre-existing framework to monitor, discipline, and respond to fiscal developments in the Eurozone, Troika policymakers created institutions piecemeal only after the onset of the crisis. These institutions were fiercely contested, both in terms of institutional design and policy authority. A cleavage emerged between the Northern economies, led by Germany, Finland, and the Netherlands, and the Southern economies, led by Italy and Spain.[23] Voters in the Northern Bloc applied pressure on their representatives to not appear too lenient towards purportedly profligate Southern governments. This political logic underscored the ascendance of strong nationalist movements in, *inter alia*, France and Finland, where the National Front and True Finns gained substantial representation,

[23] Early in the crisis, the *Financial Times* termed the former the Northern Bloc. For the originating article, see Peel, Quentin and Peter Spiegel. "Northern Exposure." *Financial Times*. 10 March 2011. Online.

respectively. In more mainstream conservative political parties, such as Germany's CDU-CSU/FDP coalition, Angela Merkel spent consider political capital convincing voters and politicians to approve a number of Troika policy measures, including bailouts and extensive liquidity operations.[24] Throughout the various bailout negotiations, the CSU's conservative constituency, the ruling party in Bavaria and coalition partner to the more moderate CDU, acted as a powerful electoral force, which circumscribed Merkel's policymaking authority. At times, it appeared that the CSU was in explicit conversation with Greece's politicians. In the negotiations following the second Greek bailout, Greek officials issued statements related to the Germany's failure to pay reparations following the Second World War. When Merkel visited Athens, Swastikas and fascist references met her in Greece's popular press. When Merkel resisted French, IMF, and debtor-country demands to write down sovereign debt in October 2012, she received a standing ovation from the CSU's membership.[25] This conservative impulse was similarly strong in other Northern economies. In the Netherlands, during the negotiations over Greece's second bailout, Prime Minister Mark Rutte proposed empowering the newly created "commissioner for budgetary discipline" with the power to eject delinquent countries from the Eurozone.[26] Rutte's proposal also reflected the pressures of leading a minority government with an ascendant far-right party, the Party for Freedom, led by the controversial Geert Wilders.

France consistently played a crucial role in moving between Northern and Southern camps. In mid-2011, amid negotiations over the sustainability of Greek debt, French politicians advocated a Brady-bond like swap, which would extend the maturity of Greek debt to 30 years.[27]

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[24] Peel, Quentin. "Bail-out revolt simmers in Germany." *Financial Times*. 13 May 2011.
[25] Peel, Quentin. "Bavarian sister party backs Merkel's balancing act; EU austerity." *Financial Times*. 22 October 2012.
[26] Spiegel, Peter and Matt Steinglass. "Dutch premier calls for EU enforcer with power to eject euro miscreants." *Financial Times*. 8 September 2011.
[27] Jenkins, Patrick, Milne, Richard and Rachel Sanderson. "French lenders lead deal to roll over Greek debt for 30 years." *Financial Times*. 28 June 2011.

After Hollande's election in May 2012, France increasingly sided with the Southern economies. Hollande's support for the South was neither consistent nor constant, however, as is explored later in this chapter and in the case studies of Chapters 6 & 7. As marginally heterodox policy failed to produce significant economic growth, Hollande's position gradually shifted France back towards the Norther Bloc. While outside the temporal scope of the study, Hollande's integration into the Northern Bloc culminated with the appointment of Emmanuel Macron as France's Finance Minister in August 2014.

In the March 2011 agreement between Eurozone leaders that eventually produced the ESM, the Northern and Southern camps debated the prospective institution's policy tools. The Northern economies argued for a more proscribed role; the Southern economies argued for a more expansive role.[28] The Northern camp favored indirect bond purchases through the government, and the Southern camp favored direct bond purchases on the open market. The former strategy would contain risk in the peripheral economies, while the latter strategy would transfer risk from the peripheral economies to the Eurozone as a whole. The Grand Bargain that emerged favored the Northern economies with limited concessions to the Southern camp.[29] The Grand Bargain expanded the lending authority of the ESM in a concession to the Southern camp. The ESM, however, was only capable of indirect bond purchases through sovereign governments; this ensured that risk remained within the peripheral economies. In a final boon for Northern economies, the summit produced additional movement on Eurozone fiscal regulation that would monitor and regulate levels of deficit and debt in member countries.

Sources of financing

[28] Peel, Quentin and Peter Spiegel. "Northern Exposure." *Financial Times*. 10 March 2011.
[29] Spiegel, Peter. "EU agrees incomplete financial package." *Financial Times*. 25 March 2011.

Governments of developed economies have three primary sources of revenue: tax revenues, bond markets, and external actors. In the context of financial crises, taxation's time horizon may prevent governments from using taxes to fill fiscal coffers. Not all taxes, however, pose similarly difficult problems in terms of time horizon. Consumption taxes on the purchases of goods and services are easy to implement and increase revenue immediately; income taxation or corporate taxation take at least a year after passing through the legislature to produce increases in revenues. Thus, in addition to the distributional logic motivating consumption-tax rates, their relatively high near-term elasticity of revenue encourages politicians to increase consumption taxes in crisis situations. In addition to the time-horizon problems facing the various types of taxation, with high prevailing rates on a number of economic activities, diminishing marginal returns to taxation may set in. These are the Laffer-curve like dynamics mentioned in Chapter 3. The dynamic of diminishing marginal returns presents a relevant problem in the Eurozone, given the relatively high tax burdens prevailing through most of Western Europe in general and the Eurozone's crisis countries in particular.

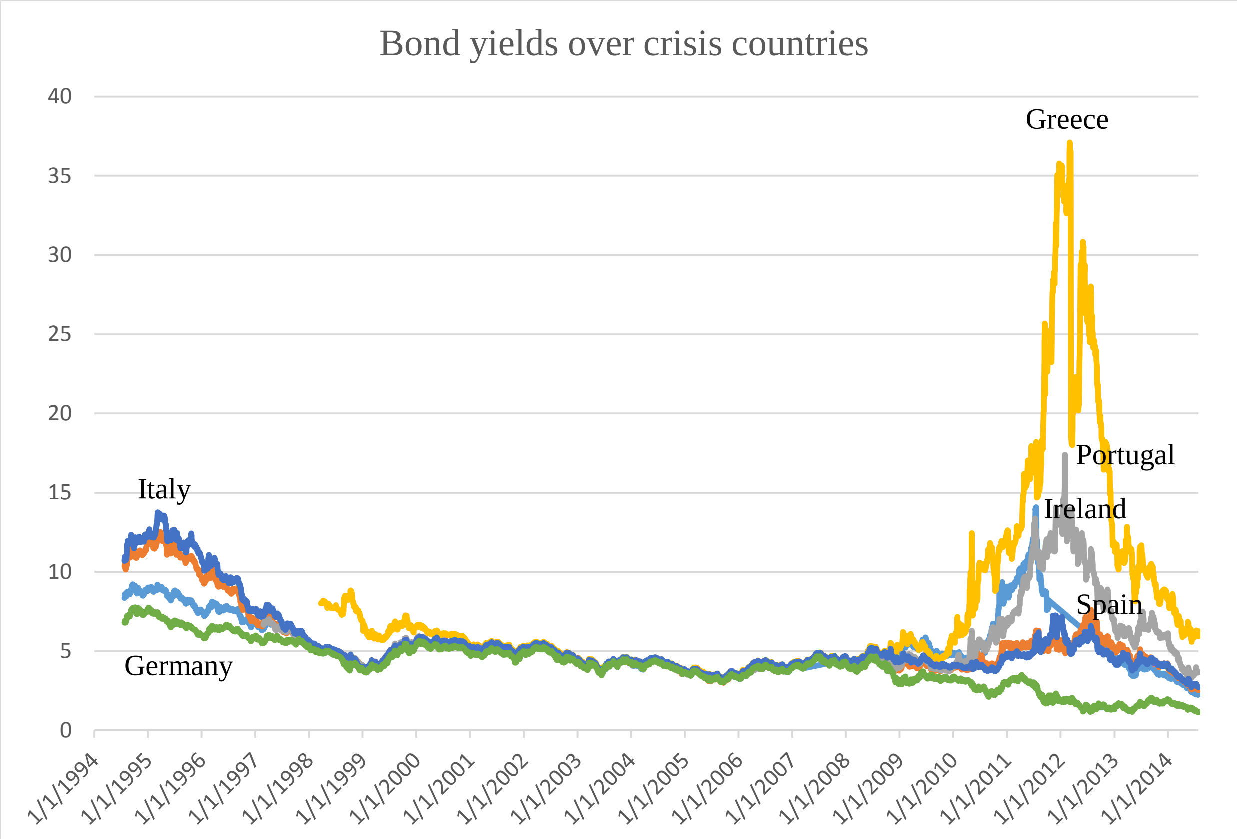

Figure 2. Bond yields over the crisis countries with German yields presented as a baseline. The vertical axis presents bond yields between 0 and 40 percent. The horizontal axis ranges from 2000 to 2014, although the study's sample only covers 2000 to 2013. County names are indicated near the country's maximum yield over the period. Each country's yield is color-coded: Germany (green); Greece (yellow); Ireland (light blue); Italy (dark blue); Portugal (gray); and Spain (red).

Borrowing on capital markets is constrained by the prevailing interest rate, referred to as a sovereign-bond yield. Sustainable bond yields are a function of pre-existing debt and macroeconomic fundamentals. Prior to the 2008 financial crisis, debt loads in crisis economies had increased significantly since the inception of the Euro. As Chapter 4 discusses, country-specific sovereign risk did not emerge until well after the onset of the financial crisis. Thus, early in the sample period, which begins in 200, governments funded fiscal deficits with capital-market borrowing. While the sustainable bond yield for refinancing debt relies on lenders' subjective perceptions of a sovereign's ability to repay, some yields are manifestly unsustainable. Figure 3 shows bond yields of the crisis countries since 2005, with German yields as a riskless baseline. Greece's and Portugal's yields near 37 and 18%, respectively, are manifestly unsustainable. Shortly after reaching these levels, the Troika restructred Greece's debt in an attempt to ease bond yields. Against the spectacular precipices of Greek and Portuguese debt, Irish yields around 12% appear nearly pedestrian. Over an extended period of time, particularly for the smaller European economies, yields in excess of 7.5% are not sustainable.

With tax increases limited by either time horizon or diminishing marginal returns and capital-market yields above sustainable yields, countries in a currency union have one remaining source of funds: external actors.[30] In the case of EU members, the Troika—and its constituent actors—served as the relevant external actor. In principle, other external actors could have provided funds; for a variety of reasons, however, alternative external actors played a minimal role. Subsequent sections address the limited cases in which viable, alternative external actors emerged.

Demand- and supply-side dynamics

Figure 1 in Chapter 1, reproduced here as Figure 3, lays out the theoretical logic relating external actors with fiscal-policy outcomes. The figure identifies two broad sets of factors, demand- and supply-side, that govern the translation of the preferences of external actors into domestic policy. The demand-side primarily reflects the relative scarcities of the three sources of funding outlined in the previous section. In the short-run, when the tax base is relatively inelastic and bond yields exceed the servicing capacity of the sovereign, countries resort to external actors. Thus, the preferences of external actors are most directly translated into domestic policy in periods of elevated bond yields. Figure 2's bond yields identify the periods in which domestic

[30] Assuming that debt is denominated in domestic currency, countries outside of a currency union could print money as an additional source of funds. Such devaluation would reduce the real debt burden. Such an avenue, however, was not available to countries in a currency union like the Eurozone.

policymakers should be most susceptible to the policy preferences of external actors. These demand conditions are most clearly satisfied, unsurpsingly, prior to each of the Troika's bailouts.

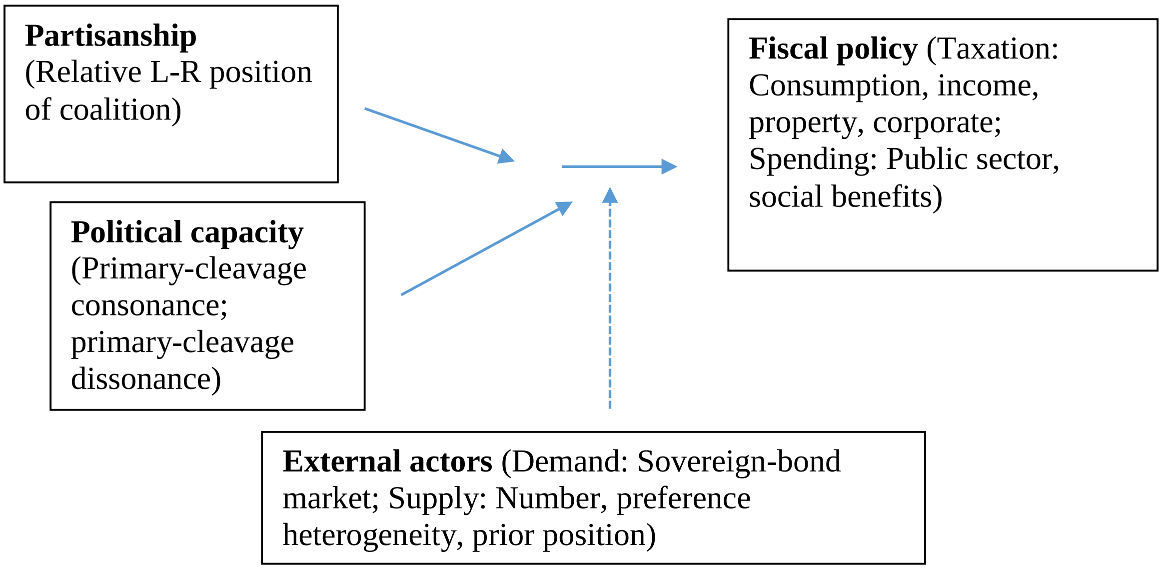

Figure 3. Schematic of the hybrid model's theoretical logic. Variables are listed in bold, with associated dimensions in parentheses.

On the supply side, preference homogeneity, the number of external actors, and the prior position of dominant actors influence the translation of external-actor preferences into domestic policy. Where the constituent members of the Troika largely agree over policy, little policy space is available in which for domestic policymakers to negotiate. Disagreements within the Troika's members emerge, as with the tension between the ECB and the IMF beginning in mid-2011, and provide domestic policymakers with room to extract concessions from external actors. These dynamics were most clearly present in the negotiation over Greece's second bailout, in which the Troika imposed losses on private bondholders, a policy anathema to the ECB in all prior negotiations. The second supply-side dynamic involves the introduction of a second external actor. In 2011, Cyprus negotiated for a €2.5 billion bailout from Russia in order to avoid the extensive conditionality required by Troika policymakers. Moreover, while it outside the scope of the present study, Tsipras' Syriza government made overtures to Russia in 2015 in an attempt to gain leverage with Troika creditors. The final supply-side dynamic involves the prior position of dominant actors, which helps to explain, *inter alia*, the evolving positions of the ECB as it amassed increasingly large positions in peripheral sovereign debt over the crisis period.

The set of policy actions available to external actors and their translation into member-countries' fiscal policies

Table 1, first introduced as Table 3 in Chapter 2, documents the Troika's involvement over the crisis sample. The table presents a limited number of Troika actions. An effectively limitless number of relevant events could be selected from among the summits, policy proclamations, and press conferences of different Troika representatives. This chapter focuses on four types of events: changes in the nominal interest rate, bailouts, significant refinancing operations, and EU-wide legislation related to fiscal policy. These events involve both the policymaking power of the Troika in addition to points of tension between the Troika's constituent actors.

Bailouts

Over the sample, the formal bailout powers have been activated six times: Greece (twice), Ireland, Portugal, and Cyprus. Spain is also coded as having received a bailout. Spanish policymakers argued at length with Troika representatives in early 2012 in order to avoid the extensive fiscal-policy conditionality that accompanied the prior bailouts of Greece, Ireland, and Portugal. Spanish policymakers succeeded in restricting the Troika's policy conditionality to financial-sector reform.[31] Because of the restriction, Troika representatives did not classify the Spanish aid as a bailout, in the sense of Greece's, Ireland's, and Portugal's. In contrast to this position, Table 1 lists Spain as having received a bailout; subsequent sections in this chapter as well as Chapter 6 examine how Spanish policymakers emerged with limited conditionality. The

[31] Atkins, Ralph, Spiegel, Peter and Victor Mallet. "Europe weighs Spain bank rescue." *Financial Times*. 7 June 2012.

strategic ambiguity adopted by the Troika with respect to Spain reflects the larger ambiguity of the Troika's relationship with the larger European economies. While the ECB and, to a lesser extent, the IMF function as a lenders of last resort to the Eurozone economies, it is unlikely that, as currently constituted short of either a fiscal or a strong banking union, the Troika commands the requisite financial resources to bail out any of the Eurozone's four largest economies: Germany, France, Italy, and Spain. In late 2011, with bond yields increasing on Italian and Spanish debt, Finland's Prime Minister Jyrki Katainen stated that it was difficult to envision that "Europe would have the resources to take a country the size of Italy into the bail-out programme." At the time private-sector economists estimated that a bail-out program for Italy would require €650 billion.[32] Put another way, the requisite aid to Italy would have totalled more than the sum of the Troika's bailout programs between 2010 and 2013, even with the bailout of Spain's financial sector included.

Event	**Date**	**Target country, institution, or area**	**Homogeneity of Troika**	**Number of external actors**	**Prior position**
Nominal interest rate	09/2008	Eurozone	Homogeneous	Discount rate drops from 4 percent in 09/2008 to a floor of 1 percent in 05/2009	
Legislation	02/2009	EU	Homogeneous	Establishes the European Economic Recovery Plan, a series of Keynesian measures to increase demand and spur economic growth within the EU.[33]	
Bailout	05/2010	Greece	Homogenous	1	Limited
Bailout	11/2010	Ireland	Homogenous	1	Limited
Legislation	02/2011	EU	Homogenous	Implements a series of measures to correct deficits that exceed those permitted under the Excessive Deficit Procedure.[34]	

[32] Barber, Tony. "Enter the technocrats." *Financial Times*. 12 November 2011.
[33] "A European Economic Recovery Plan." *EUR-Lex*, 26 November 2008. Web. < http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1439818628650&uri=URISERV:ec0004>.
[34] "The corrective arm: the excessive deficit procedure." *EUR-Lex*, 2 February 2011. Web. <http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1439819458086&uri=URISERV:l25020>.

Nominal interest rate	04/2011	Eurozone	Homogenous	Discount rate increases from 1 percent in 04/2011 to a ceiling of 1.5 through 10/2011	
Bailout	05/2011	Portugal	Homogenous	1	Limited
Nominal interest rate	10/2011	Eurozone	Homogenous	Discount rate drops from 1.5 percent in 10/2011 to a floor of 0.25 percent in 11/2013	
Bailout	12/2011	Cyprus	Homogenous	2	Russian deposits; Greek holdings of Cypriot debt
LTRO	12/2011	Banks in Greece, Ireland, Italy, and Spain	Heterogeneous	1	Sovereign debt from bailouts;
Legislation	12/2011	EU	Heterogeneous	"Six-pack" enters the force establishing limits on both government debt and deficit. Takes steps to improve EU surveillance of both.[35]	
LTRO	02/2012	Banks in Greece, Ireland, Italy, and Spain	Heterogeneous	1	Sovereign debt from bailouts; debt from prior LTRO
Bailout	02/2012	Greece	Heterogeneous	1	ECB's holding of Greek debt
Legislation	03/2012	EU	Heterogeneous	Treaty on Stability, Coordination, and Governance—alias "Fiscal Compact"—expands the EU's monitoring and advisory powers with respect to the budgets of member governments.[36]	
Bailout	06/2012	Spain	Heterogeneous	1	ECB's holdings of Spanish sovereign bonds
OMT	09/2012	Eurozone banks	Heterogeneous	1	Sovereign debt from bailouts; debt from LTRO's
Bailout	04/2013	Cyprus	Heterogeneous	2	Limited
Legislation	05/2013	EU	Heterogeneous	"Two-pack" enters into force, which formalizes the oversight process of Brussels with respect to member-country budgets.[37]	

Table 3. Relevant events involving external actors. The type of event, whether a change in the nominal interest rate (for the time series, see Figure 1 of Chapter 5), a bailout, a LTRO, or legislation, is noted in the first column. The second column indicates the month and year of the event. The third column indicates the crisis country or institution

[35] "Surveillance of budgetary policies." *EUR-Lex*, 1 June 2012. Web. <http://eur-lex.europa.eu/legal-content/EN/TXT/?qid=1439819458086&uri=URISERV:l25019>.

[36] "Treaty on stability, coordination and governance in the economic and monetary union." *European Commission: Press Release Database*, 1 February 2012. Web. <http://europa.eu/rapid/press-release_DOC-12-2_en.htm>.

[37] "'Two-pack' enters into force, completing budgetary surveillance cycle and further improving economic governance for the Euro area." *European Commission: Press Release Database*, 27 May 2013. Web. <http://europa.eu/rapid/press-release_MEMO-13-457_en.htm>.

(in the case of bank bailouts) targeted. The fourth column indicates the relative homogeneity of the Troika in a particular event. The fifth column indicates the number of relevant external actors. The sixth and final column indicates the prior position of relevant external actors.

Conventional and unconventional monetary policy

The ECB conducts extensive monetary-policy operations within the Eurozone. In the context of the financial crisis, most of these operations aimed to ensure systemic liquidity and to prevent bond contagion between member countries. Chapter 4 examines the latter phenomenon is explored more formally and in greater depth. Four sets of measures constituted the ECB's policy measures over the sample: changes in the discount rate; Security Market Programme (SMP), Outright Monetary Transactions (OMT), and long-term refinancing operations (LTRO's). The first constitutes conventional monetary policy and refers to ECB's control of the overnight, interbank lending rate. By manipulating the rate, the ECB intends to influence the money supply and, by extension, inflation. The second, third, and fourth measures refer to unconventional monetary policies, which the ECB employs at the nominal zero-lower bound (ZLB), i.e., the limit of conventional monetary policy.

SMP and OMT refer separately to programs of sovereign-bond purchases. Through these programs, the ECB acquires sovereign debt. Sovereigns would then use the borrowed funds to shore up stressed financial institutions. The key difference between the SMP and OMT involves conditionality. Historically, SMP facilities could be accessed without conditionality. To access the OMT facility, however, target countries need to have an open line of credit with either the EFSF or the ESM. Effectively, this requires target countries to have opened bailout programs with the Troika's institutions. To increase the power of creditor institutions, the conditionally-focused OMT replaced with SMP in September 2012. A subsequent case study in this chapter explores the debate over, and founding, of the OMT.

LTRO's refer to a specific, significant, and politically controversial activity. Typical liquidity operations by central banks around the world involve the exchange of creditworthy collateral for cash for a short period of time, often overnight. LTRO's differed in both the quality of collateral accepted and the length of the loan. As collateral for LTRO's, the ECB accepted asset-backed securities (including the mortgage-backed securities central to the beginning, and transmission, of the financial crisis) and sovereign bonds.[38] The ECB's standard for creditworthy collateral shifted with the intensity of the crisis. For example, in May 2010, with Greek banks facing massive withdrawals, the ECB suspended the minimum crediting rating for Greek bonds used in liquidity operations.[39] Moreover, in contrast to the brief terms of standard liquidity operations, bonds refinanced by LTRO's matured in three years. In addition to the technical differences distinguishing LTRO's from standard liquidity operations, LTRO's dwarfed liquidity operations in terms of sheer size. The two rounds of LTRO conducted in December 2011 and February 2012 totaled nearly €1 trillion.[40] Table A2 in the appendix to this chapter provides a sense of scale for the size of the LTRO's relative to the ECB's balance sheet; prior to the start of the LTRO's, the ECB's balance sheet contained €2.5 billion worth of assets.

From the Troika's perspective, LTRO's are exceptional in their blurring of the line between monetary and fiscal policy. This is also the case with SMP, and later OMT, that either implicitly or explicitly target the bond yields of particular Eurozone countries in contrast to the Eurozone's formal mandate of price stability. The ECB's right to conduct fiscal policy veiled as monetary policy is contested, and, once again, juxtaposes Northern countries that advocate for a more restricted role with Southern countries that argue for a more expansive ECB role with

[38] "ECB announces measures to support bank lending and money market activity." *European Central Bank*, 8 December 2011. Web. < http://www.ecb.europa.eu/press/pr/date/2011/html/pr111208_1.en.html>.
[39] Oakley, David and Ralph Atkins. "Stability fears spread after bail-out of Greece." *Financial Times*. 4 May 2010.
[40] Enrich, David and Charles Forelle. "ECB gives banks big dollop of cash." *Wall Street Journal*. 1 March 2012.

respect to fiscal policy. Often, the ECB's fiscal-lite policy occupies an acceptable middle ground between the two camps. The unconventional monetary policies confine risk to sovereigns by purchasing troubled bonds indirectly through governments rather than directly from distressed financial institutions. Northern politicians can return to their constituencies and announce that they have not bailed out peripheral debtors. The Southern economies favor the limited relief on sovereign yields to the alternative of inaction. The fundamental problem with LTRO's as fiscal-lite policy is that markets realize that LTRO's are monetary policy, masquerading as fiscal policy, which stem from a basic cleavage between Northern and Southern economies. At the limit, financial markets recognize that this cleavage prevents a complete fiscal union and that, notwithstanding Draghi's determination to "do whatever it takes," the ECB is fundamentally constrained to reduce the fiscal burden of Eurozone member countries.

EU-level legislation

The final set of policies included in Table 1 involve EU-wide policy changes. The primary means by which they influence the fiscal policy of Eurozone member states is through the disbursement of funds by such institutions as the European Investment Bank (and other EC-led institutions) and the application of the Stability and Growth Pact (SGP), the text in the founding charters of the European Union that limits the debt of member states. The disbursement of funds characterized the early EC-led response. Later in the period, the Troika relied almost exclusively on refining and enforcing the SGP. SGP-related policies fall broadly into two categories. Regulations in the first camp clarify and strengthen the precepts of the SGP. Among other things, these measures encouraged member states to make balanced-budget amendments to their constitutions. Short of constitutional amendments, the regulation encouraged the incorporation of balanced-budget measures into domestic law. The second category adds disciplinary mechanisms to the SGP framework. These measures allow for the imposition of fines of member countries consistently in violation of the SGP. Much of the debate over both types of regulation involved the application of policy in exceptional economic circumstances. The SGP itself, and subsequent regulation, allowed for deficits and debts in excess of the nominal targets during economic recessions. The applicability of this regulation remains a persistent source of financial-market uncertainty and, once again, reflects the tension between Northern and Southern camps. Enmeshed with the political tension over SGP-related enforcement, the Troika faces a credibility program when enforcing the SGP, particularly in the context of a financial crisis. It is unclear whether the Troika would add to the fiscal burden of a country facing severe fiscal problems.[41]

One of the primary obstacles to the influence of EU-level legislation on domestic politics is that amendments to EU treaties require approval in domestic legislatures. Significant changes to the EU's role in the fiscal policy of member states typically requires a treaty amendment, given the sensitives surrounding the "bailout clause" in Article 125 of the Lisbon Treaty.[42] In practice, this means that, after Eurozone ministers approve area-wide legislation, senior ministers need to return home to secure their domestic constituencies' approval. The method of ratification varies by country. In some countries, such as Ireland, popular referenda are required to approve any major changes to Ireland's relationship with the EU. In Germany, on the other hand, a two-thirds majority of parliament is required. This tension was apparent in the debate over the fiscal compact negotiated by Eurozone ministers in late 2011 and early 2012. The subsequent extended debate into domestic legislatures. Seen as a relatively conservative piece of legislation that

[41] This lesson was reinforced by the backlash and renewed recession that occurred following the ECB's increased rates in the middle of 2011 from fears over pent-up inflation.
[42] "Consolidated version of the treaty on the function of the European Union." *EUR-Lex*, 26 October 2012. Web. <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:12012E/TXT&from=EN>.

strengthened the surveillance and enforcement of the ECB, even a conservative Chancellor Merkel struggled through the summer to secure the Bundestag's approval.[43] Conservative members of the governing coalition feared that the establishment of the European Stability Mechanism, the quid pro quo for the Southern economies in exchange for strengthening of the SGP, would exacerbate problems of moral hazard, seen by the Northern economies as the primary risk emanating from policies adopted in response the crisis.[44]

Six vignettes: The Troika and the financial crisis

From the supply-side perspective of Figure 2, the bailout process worked relatively smoothly in the cases of the first Greece's first bailout, Ireland's, and Portugal's. While extensive public, and occasionally violent, unrest emerged in response to the Troika's stipulations,[45] the Troika consistently acted as a homogenous unit. In these instances, crisis countries were not able to take advantage of divisions between organizations within the Troika. This is one advantage, from the perspective of the Troika, of grouping potential aid organizations into a single organization. So long as the Troika maintains a unified front, it can project a single voice in the affairs of crisis countries. On the basis of this organizational perspective, two potential developments would threaten the hegemony of the Troika: divisions within the Troika's organizations and the arrival of alternative funding organizations. Both of these contingencies emerged over the crisis period and produced distinct organizational and policy responses on behalf of the Troika. These changes in turn altered the constraints applied by the Troika within crisis countries. The following six vignettes explore both of these supply-side dynamics. The

[43] Peel, Quentin. "Merkel accused of putting harshness before growth." *Financial Times*. 18 June 2012.
[44] Southern economies, on the other hand, primarily focused on the growth-limiting implications of fiscal adjustment.
[45] In late April 2010, police dispersed protestors outside of Greece's finance ministry with tear gas: Hope, Kerin. "Greece agrees to €24bn in cutbacks." *Financial Times*. 30 April 2010. Then, in early May, three bank workers died in fires started by protestors: Hope, Kerin, Barber, Tony and David Oakley. "Greek premier vows to push on with cuts as three bank workers die in Athens protest." *Financial Times*. 6 May 2010.

first examines the relatively homogenous preferences within the Troika over the first three bailouts. The second analyzes the role of preference heterogeneity as a result of changes in the technocratic preferences of the IMF in mid-to-late 2011. In addition, the vignettes explore Figure 2's third and final supply-side dynamic that relates to the prior position of funding institutions, particularly in sovereign-debt markets. The third vignette explores how the ECB and creditor governments behaved differently towards crisis countries, once the creditor institutions had amassed significant positions in the sovereign debt of crisis countries. The fourth vignette then explores the central credibility problem facing the Troika with respect to large economies such as Italy and Spain. The vignette suggests that, adapting Sorkin's terminology, such economies are "too-big-to-bail." The fifth vignette explores how creditor countries reasserted themselves following ostensible concession to Southern economies at the 2012 Eurozone Summit. Creditor countries protected their financial positions by replacing the SMP's unconditional bond-purchase program with the OMT's stringent conditionality. The sixth and final vignette analyzes the arrival of Russia in bailout negotiations with Cyprus (and, to a lesser extent, Greece) and the consequences of a second external actor for fiscal-policy adjustment at crisis countries.

Vignette #1- Preference homogeneity: The first three bailouts

As a piecemeal organization, constructed in the context of conflict between the Northern and Southern economies, the Troika presented a remarkably unified front in the first years of the crisis. Roughly, this unity was apparent in the first several policy actions listed in Table 3, as indicated by the homogenous coding in the table's fourth column. In May 2010, the Troika orchestrated the first bailout of Greece. With the increasing awareness of its incumbent financial responsibilities, in June 2010, the Troika established the EFSF. In October 2010, Ireland became the first country to apply for a bailout under the auspices of the EFSF. With spreads on both

Greek and Irish debt increasing unabated, as displayed in Figure 2, the Troika expressed an intention to buy sovereign bonds through the ECB's SMP facility in order to ease capital-market pressures on peripheral economies. The central coalitions and heterogeneous preferences within the Troika first manifested in discussions over the mechanics of SMP's bond purchases. A coalition of Northern European countries—Germany, the Netherlands, and Finland—pushed for indirect purchases. In an indirect purchase, the ECB lends money, i.e., buys bonds, to the central governments, which then purchase the debt of troubled domestic institutions, e.g. banks, pension funds, etc. Thus, indirect purchases largely contain financial risk within the crisis countries; in doing so, such purchases limit the moral hazard facing Southern economies and, more controversially, financial contagion. A group of primarily Southern European countries, including those most directly affected by the financial crisis, advocated for direct purchases. In a direct purchase, the ECB purchases the bonds of troubled crisis-country institutions directly on the open market. Such direct transactions would reduce the risk of default by transferring some risk to the wealthier North. This is a much easier argument to sell in a technocratic setting dominated by policy experts, compared with a democratic setting populated by parties and voters. Even had Northern-country politicians preferred direct purchases, it would have been difficult for Northern voters to countenance assuming the financial risk that stemmed from the profligate "PIIGS" behavior. The *Financial Times* detailed the pressure faced by Angela Merkel from the conservative wing of her governing coalition.[46] What emerged in March 2011 as the Grand Bargain aligned closely with the preferences of the Northern European countries. The lending authority of the EFSF expanded but only in the context of indirect purchases. Risk thus largely remained within crisis countries.

[46] Peel, Quentin and Peter Spiegel. "Northern Exposure." *Financial Times*. 10 March 2011. Online.

The insulation of risk in crisis countries proved the key point around which Northern economies cohered as preference heterogeneity emerged later in the crisis period. In a similar vein to the SMP-related discussion, proposals emerged for Eurobonds that would be jointly issued by the Eurozone economies.[47] Such bonds, at least partially, would take the place of sovereign debt. Commentators argued that, without a significantly closer political union, Eurobonds would further instantiate moral hazard and create incentives for Southern economies to borrow without adopting domestic reforms. From the perspective of Northern economies, Eurobonds proposals presented less credit than financial risk that would spread to other areas of the economy. Such spillover was observed in the accession-related, convergence trade, shown in Figure 2, that produced the property bubbles in Ireland and Spain as well as the increasing public-sector employment burden[48] across peripheral economies (but in Greece, in particular).

Even with the homogeneous preferences early in the crisis period, the Troika's preferences were not directly translated into domestic policy. The contrast of Ireland and Greece provides a case in point. In exchange for indirect bond purchases, enabled by March 2011's Grand Bargain, the Troika required that Ireland raise its corporate-tax rate of 12.5%, which was viewed as unfairly competitive by policymakers in Berlin and Paris. Ireland rejected the Troika's offer, paving the way for the ECB purchases of Greek, but not Irish, sovereign debt.[49] Tension over corporate-tax reform constituted the key stumbling block between Dublin and Brussels policymakers throughout the sample. Moreover, it illustrates the limits of the Troika's influence

[47] Johnson, Steve. "Eurobond solutions picks up support." *Financial Times*. 5 December 2011.
[48] Figure A2, in the appendix to this chapter, graphs the level of public-sector compensation over time. The figure shows large and sustained increases in the public-sector compensation of crisis countries relative to non-crisis countries, a trend that continued until the expenditure-centric austerity that characterized the post-crisis period.
[49] Spiegel, Peter. "Leaders cut surprise deal on key reforms." *Financial Times*. 14 March 2011.

in the fiscal policy of crisis countries, particularly when confronted with a unified set of political parties.

While dissent emerged between Northern and Southern economies in debates over the Troika's approach in the first three bailouts, the expenditure-driven austerity approach advocated by Northern countries dominated. Coupled with the elevated bond rates that prevented extensive capital-market borrowing by crisis-country governments, the unity of the Troika provided a relatively hard constraint on domestic politicians. While domestic coalitions had discretion on the type of fiscal adjustment adopted, they had little choice that adjustment would proceed. Such flexibility contrasts with the period of depressed bond yields immediately following the failure of Lehman Brothers. Without the hard funding constraint produced by being locked out of capital-markets, crisis countries, with the exception of Greece, enacted inflationary policies. The variation in bond-yield pressure thus mediates the influence of external actors in the affairs of target countries.

Vignette #2- Emergent preference heterogeneity: Heterodox policy and the IMF's personnel changes

As the Greek bailout extended into its second year with little foreseeable prospects for economic growth, a number of important voices challenged the Troika's fiscal orthodoxy. By this point, it was becoming increasingly clear that Greece would need a second bailout, either in the form of another round of funds or debt restructuring. In July, a lead article in the *Financial Times*[50] advocated a Brady-bond-like swap for Greece. In 1989, during George H.W. Bush's administration, Secretary of the Treasury Thomas Brady replaced much of the sovereign debt from several Latin American economies with bonds denominated in US dollars. The associated

[50] Jenkins, Patrick, Milne, Richard and Rachel Sanderson. "French lenders lead deal to roll over Greek debt for 30 years." *Financial Times*. 28 June 2011. Online.

restructuring reduced the real debt burden of Latin American economies. Moreover, the debt's denomination in US dollars eliminated the possibility of Latin American governments printing money to further reduce the real debt burden.

The Brady-bond parallel was imperfect for two primary reasons. First, because of their existing in a currency union without control over either monetary policy or exchange-rate interventions, the Eurozone's peripheral countries remained unable to affect the real debt burden through the primary means employed by the Latin American economies in the late 1980's. In other words, monetary-policy credibility was never at issue for Eurozone economies. Second, little political will existed for debt restructuring in the primary creditor economies, i.e., Germany. In the case of Brady bonds, the United States offered generous terms to private-sector bondholders that participated in the bond swap. Germany, for a variety of reasons, which were primarily political, was unwilling to play an analogous role.

By the middle of 2011, notwithstanding the debates over relatively heterodox policy, Ireland and Greece exhibited signs of austerity fatigue. Bond yields continued to escalate in Ireland, Portugal, and Greece, as incumbent governments fell in February, June, and November of 2011, respectively. A number of important policy and personnel changes within the Troika fueled the deteriorating consensus over austerity. The emergent policy heterogeneity was clear in the contrast of the successive rate increases by the ECB with a research paper produced by the IMF. After consecutive meetings in April and July 2011, as shown in Figure 1, the ECB raised its main policy rate by 0.25 percentage points to 1.25% and 1.5%, respectively.[51] These rate increases occurred concurrently with negotiations over Portugal's May 2011 bailout. The contractionary policy trajectory of the ECB remained in place until November 2011, when Mario

[51] Atkins, Ralph. "ECB raises interest rates to 1.5%." *Financial Times*. 7 July 2011.

Draghi replaced Jean-Claude Trichet as the head of the ECB. As the ECB doubled down on its conservative position, the IMF's position evolved to reflect both new leadership as well as additional research. On the personnel side, with the revelations of sexual misconduct by Dominique Strauss-Khan, Christine Lagarde took over as Managing Director of the IMF in July 2011. The shift in leadership arrived at a critical time for the IMF, in which two sources of discontent gathered strength. The first derived from the IMF's diverse geographic constituency; the second involved the increasing empirical evidence undercutting arguments for the variety of expansionary austerity advocated by the ECB. Unlike the EC and the ECB, with constituencies exclusively within Europe, the IMF's membership includes developing and developed economies from around the world. Founded following the Second World War, the IMF oversaw and conducted extensive reforms following the Latin American debt crises in the 1980's and the East Asian currency crises in the 1990's.[52] Following the 2008 financial crisis, these countries increasingly felt that the IMF, at the behest of its European partners in the Troika, were lenient with European debtors compared with the historical treatment of the Latin American and East Asian countries. In an interview with the *Financial Times*, Paulo Batista—a member of the IMF's Executive Board, who represented Brazil and a number of other countries—questioned whether Lagarde could "transcend her European origins."[53] In September 2011, partly in response to the growing resentment and prior to the disbursement of Troika aid to Greece, the IMF formally expressed dissatisfaction with Athens' movement on its budget deficit. While the

[52] For a primer on each, refer to Oatley (2011): pp. 298-322 on the Latin American debt crisis and pp. 323-45 for the East Asian financial crisis.
[53] Beattie, Alan. "IMF warned over fresh Greek loan." *Financial Times*. 28 July 2011. Online.

European partners in the EC, with the partial exception of Germany and the Netherlands, were largely satisfied with Athens' progress, the IMF refused to disburse further loans.[54]

In addition to the constituency-related tension, heterodox voices within the IMF gained an important ally with the publication of an IMF working paper that challenged the empirical groundings of expansionary fiscal austerity.[55] The authors argued that previous estimates of the macroeconomic effects of austerity had been biased upwards, because they failed to control for changes in the macroeconomic environment correlated with the adoption of austerity policy. Once the authors controlled for these changes, they showed that fiscal austerity produced adverse macroeconomic consequences in the short-run. These contractionary effects were contrary to the salutary dynamics implied by the Washington Consensus. Viewed as an isolated working paper, the document was not particularly important. However, when considered as indicative of the IMF's growing equivocation over the effectiveness of continued austerity, the working paper gained importance. Whereas the Troika began as a unified organization, the July 2011 working paper indicates the emerging splits within the Troika, splits that crisis countries would soon be able to exploit.

With the Eurozone's increasing public-debt burdens, and the growing empirical evidence of austerity leading to diminished economic growth, at least in the short-term, the primary policy platform espoused by the technocratic IMF shifted to debt reduction. The relative flexibility of the IMF's policy positions, relative to the ECB's, reflected differences in the preference formation of the respective organizations. The ECB's preference arose from Germany's insistence on expenditure-centric reform; the IMF's arose from a technocratic belief that

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[54] Spiegel, Peter, Beattie, Alan and Joshua Chaffin. "Lagarde warns IMF will hold back loan if Athens fails to act." *Financial Times*. 16 September 2011. Online.
[55] Guajardo, Jaime, Daniel Leigh, and Andrea Pescatori. "Expansionary austerity? International evidence." *Journal of the European Economic Association* 12.4 (2014): 949-968.

expenditure-centric austerity produced superior economic outcomes. When research and empirical reality challenged the expenditure-centric paradigm, the IMF's preferred policy changed, from expenditure adjustment to debt relief. The ECB's, dependent on the political conditions in creditor countries more than technocratic beliefs, remained constant.

Vignette #3- Implications of growing prior positions: Policy shift at the ECB

As Lagarde's replacement of Strauss-Khan signaled a policy shift at the IMF, Mario Draghi's replacement of Trichet in November 2011 signaled a policy shift by the ECB. Bond-yield spreads skyrocketed, as shown in Figure 2, following the ECB's successive rate increases in April and July 2011. As with Lagarde's replacement of Strauss-Khan, there were questions about the influence of national origin on the direction of policy.[56] Except, whereas Lagarde had reigned from France, Draghi hailed from Italy. Replacing the austerity champion Trichet, many observers saw in Draghi a chance for the ECB to shift course. And, in a limited sense, Draghi's ascendance did signal a change in course. Figure 1 shows the main policy rates from the Fed, the ECB, and the BOE. Draghi gradually reduced rates beginning in November 2011 but only reached the BOE's level in May 2013. At the same time as Draghi announced lower target rates, the ECB implemented successive rounds of LTRO's. These large-scale asset purchases in December 2011 and February 2012 shifted nearly €1 trillion in collateral onto the ECB's balance sheet. The relatively expansionary conventional and unconventional monetary policies implemented under Draghi contrasted with the more conservative position taken by the ECB under Trichet. In a concession to the Northern Bloc, however, bond purchases under the auspices of LTRO's remained indirect and thus largely confined risk to national balance sheets. In addition to the evolution in monetary policies, the ECB also temporarily shifted its position on

[56] Riotta, Gianni. "To Draghi, it is numbers not nationality that matter." *Financial Times*. 7 November 2011. Online.

fiscal policy with respect to debt restructuring. In the aftermath of the IMF's repudiation of expansionary austerity, IMF economists pushed for debt restructuring as a mean of gaining fiscal solvency for crisis economies in general and Greece in particular. And, whereas in prior bailouts, the ECB had been reluctant to impose losses on private-sector bondholders, the Troika imposed losses on private bondholders in the second bailout of Greece.

While the shift in the IMF's position and the consequent preference heterogeneity contributed to the Troika's policy change, a second supply-side dynamic characterized by Figure 3, applied in the second Greek bailout. The first extensive bond purchases made under the SMP and LTRO's built up the ECB's positions in the liabilities of peripheral economies. While, *prima facie*, the debt reduction appeared an unmitigated victory for the IMF, the ECB restricted debt restructuring to private-sector holdings. Private-sector holdings accounted for €206 billion of outstanding Greece's roughly €350 billion in outstanding debt. Thus, the ECB protected its large prior position in the sovereign debt market while partially satisfying key constituencies within the IMF.

Vignette #4- Credibility: 2012 Eurozone summit and the "bailout" of Spain

During the first four bailouts conducted by the Troika—in Ireland, Portugal, and twice in Greece—policymakers expressed concerns about contagion between crisis countries and non-crisis countries. Chapter 4's discussion of bond yields explored the dynamics of contagion explored in greater depth. Here, it is important to note that Troika policymakers, particularly those at the EC/ECB, were primarily concerned with creating a "firewall" around peripheral European economies. Later in the crisis period, the Troika was primarily concerned that, if bond yields escalated in Italy and Spain, Troika institutions would not command sufficient resources to bail them out. This dynamic marked an important difference between the Troika's relationship with the smaller European economies and the continent's largest economies: Germany, France, Italy, and Spain. The latter are "too-big-to-bail." This provided policymakers from larger economies with leverage, resembling a game of chicken, vis-à-vis the Troika.

In 2012, as bond-yield spreads declined in peripheral economies following the restructuring of Greek debt, the Spanish spread started to increase, primarily over fears for the collective health of cajas, Spain's under-regulated regional banks. The June 2012 Eurozone Summit highlighted the central credibility problem facing Troika policymakers in negotiations with the indebted, larger European economies. Prior to the Summit, the Spanish government requested €100 billion with which to recapitalize its banks. Crucially, the Spanish government requested that bank debt be purchased directly rather than indirectly by the Troika.[57] Spanish policymakers hoped that direct purchases would transfer risk away from Spain and thereby reduce the upward pressure on Spain's sovereign-bond yields. At the Summit, tension increased between Northern economies (led by Germany) and the IMF over precisely the issue of direct ECB involvement in Spain's banking crisis. By the Summit's end, policymakers had produced an agreement that combined €120 billion in growth measures with an agreement for the ECB to recapitalize banks directly. Chapters 6 & 7 explore the associated negotiations and their implications for fiscal policies adopted in crisis countries.

However, in the following months, as Northern leaders tried to sell these policies to their domestic constituencies, two key provisions changed.[58] First, direct purchases of bonds would only occur in response to formal requests to the Troika by crisis countries and subject to Troika conditions. This arrangement, in all but name, reproduced the conditionality of bailouts. Second,

[57] Mallet, Victor, Johnson, Miles, and Peter Spiegel. "Defiant Spain angers troika by striving to avoid formal rescue." *Financial Times*. 2 June 2012.
[58] Spiegel, Peter. "Deal over bank bailout thrown into doubt." *Financial Times*. 26 September 2012.

Germany, the Netherlands, and Finland announced that the banking agreement would not apply to legacy assets. ECB recapitalization would apply only to assets acquired from the date of the Summit onwards. Assets acquired prior to the Summit, including almost all of the toxic debt on bank balance sheets, would not be subject to the agreement. This posed a significant problem for Spain's cajas that possessed significantly overvalued assets that had not been marked-to-market since the onset of the financial crisis. These two measures largely reversed the Southern camp's purported gains. Moreover, these measures indicated the importance of domestic politics in both crisis and non-crisis countries in the Troika's decision-making, and the wide gap between Summit proclamations and domestic passage. In the fallout from the redesigned agreement, the split between the IMF, the EC/ECB, and dominant creditor countries became clear. In the final agreement, the IMF did not participate in the bailout of Spanish banks. Moreover, dissent increasingly emerged within senior IMF leadership. Peter Doyle, a former division chief of IMF's European Department, resigned from his position, citing the both the broad failure of the Fund's leadership to provide policy alternatives to austerity as well as the Fund's pervasive European bias.[59]

Vignette #5- Affirming conditionality: From the SMP to OMT

Following his appointment as President of the ECB, Mario Draghi committed the ECB to maintaining the Eurozone intact. In a July 2012 speech, Draghi stated that "the ECB is ready to do whatever it takes to preserve the Euro." Draghi went on to reassure his audience, saying "believe me, it will be enough."[60] In September 2012, with yields on peripheral debt increasing, following extended electoral uncertainty in Greece and Monti's declining political credibility in

[59] Talley, Ian. "Senior IMF economist resigns, cites suppression and Europe bias." *The Wall Street Journal*. 20 July 2012.
[60] "Verbatim of the remarks made by Mario Draghi." *European Central* Bank, 26 July 2012. Web. <https://www.ecb.europa.eu/press/key/date/2012/html/sp120726.en.html>.

Italy, Draghi introduced Outright Monetary Transactions (OMT's), which would purchase the debt of troubled countries in exchange for conditional reforms.[61] The OMT replaced the ECB's prior Securities Markets Programme (SMP). The primary difference between OMT and LTRO/SMP was that the OMT explicitly institutionalized conditionality, which would include quarterly visits by Troika representatives and other features characteristic of involvement with the EFSF's and ESM's bailout facilities. Indeed, to access the OMT's lending facilities, a recipient country would need to have an open line of credit with either the EFSF or the ESM. Particularly, given the deteriorating electoral contexts in Greece and Italy, the requisite conditionality of the OMT program raised questions about the program's usefulness in a crisis situation characterized by substantial political uncertainty. Conceivably, in such a situation, no domestic policymaker would be able to credibly commit to conditional reforms. As a result, either the ECB would have to violate a primary, founding principle and buy bonds without credible commitment to reform[62] or the ECB would have to wait for a credible government, risking financial and economic turmoil in the interim. Ironically, it was precisely this type of political uncertainty with detrimental financial-market implications (inconclusive May 2012 elections in Greece that led to the highest bond-yield spreads observed in the sample) that compelled ECB to create the program. In March 2013, the restrictions for participation in OMT became more onerous, as Draghi announced that not only would participating countries need to be actively undergoing macroeconomic adjustment, but they would also have to be "on the

[61] Steen, Michael. "Weidmann isolated as ECB plan approved." *Financial Times*. 7 September 2012.
[62] Given that the key role of the modern, independent central bank is to reduce discretionary monetary policy, and thereby minimize uncertainty over the path of the future money supply, violating an underlying rule would set an unacceptable precedent for many monetary policymakers. See Kydland & Prescott (1977) for the seminal paper on rules-based versus discretionary monetary policy: Kydland, Finn, and Edward Prescott. "Rules rather than discretion: The inconsistency of optimal plans." *The Journal of Political Economy* (1977): 473-491.

market by themselves."[63] This further restricted the ECB's ability to respond to the financial-market consequences of a political crisis. Thus, not only would OMT-target countries need to have an open line of credit with the EFSF/ESM, a target would also need to be in a financially sound position with full access to bond markets. The OMT's increasingly onerous restrictions revealed the deep political tension of fiscal union in the Eurozone, a tension dominated by the conservative Northern economies.

The market-access restriction also introduced an important asymmetry with respect to Eurozone countries. Bond yields were lower on large countries not only as a function of macroeconomic productivity but also because market actors recognized that the failure of one of the largest economies (e.g., Germany, France, Italy, and Spain) would lead to the collapse of the Eurozone. Market actors knew the lengths that Eurozone leaders would go to prevent such a economic, and political, catastrophe. Thus, markets priced in the added willingness of Eurozone leaders to back large economies. This represented the sovereign analog to the systemically important financial institutions deemed "too-big-to-fail" by Andrew Sorkin following the 2008 financial crisis.[64] This dynamic also explained Spain's ability, uniquely among bailout recipients, to sharply circumscribe conditionality. Within the context of OMT and the ECB's policy, the yield advantage granted to larger economies meant that, under financial-market stress, larger countries such as Italy and Spain would retain access to ECB programs; smaller countries, on the other hand, such as Greece, Ireland, and Portugal, would be locked out of such programs.

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[63] Randow, Jana. "European Central Bank President Draghi news conference." *Bloomberg Business*. 7 March 2013. http://www.bloomberg.com/news/articles/2013-03-07/european-central-bank-president-draghi-news-conference-text-.
[64] Sorkin, Andrew. *Too big to fail: The inside story of how Wall Street and Washington fought to save the financial system—and themselves*." United States: Viking Press, 2009.

Perversely, anticipating and internalizing the logic of such asymmetric program access, markets further drove the yields of large and small economies apart.

Vignette #6- An additional external actor: Russia's involvement in Cyprus

Two dynamics threatened to exacerbate the collective action problem facing Troika policymakers: the emergence of preference heterogeneity within the Troika as well as additional external actors. By combining the IMF with the ECB and the EC, the institutional design of the Troika prevented, to some degree, the collective action problems that confront multiple actors. Throughout Southern and Western Europe, no organizations challenged the primacy of the Troika. In Eastern Europe, however, the Troika's primacy was not a given, particularly with respect to Russia. In December 2011, Cyprus's AKEL party faced an increasing deficit, exacerbated by an explosion at a power plant that substantially reduced the country's power supply.[65] Having observed the Troika's overbearing policy mandates in Greece, Ireland, and Portugal, the Cypriot government sought alternative sources for funds. Flush with hard currency as a result of high commodity (in particular, oil) prices, Moscow extended funds without conditionality. Cypriot politicians explicitly framed aid from Russia as a less onerous alternative to aid from European financial institutions.[66] Moscow's interest stemmed from the geopolitical competition for influence in the region in addition to the large proportion of Russian deposits in the Cypriot banking system. These deposits would potentially be at risk if the Troika imposed private-sector restructuring, as was being discussed in Greece at the time. In total, Moscow supplied €2.5 billion.[67] Importantly, while there was no explicit policy conditionality, there was

[65] Dewhurst, Patrick. "Breaking news: Huge explosion at Evangelos Florakis naval base." *Cyprus Mail*. 12 July 2011.
[66] Psyllides, George. "Public servants: If Cyprus needs a bailout, it won't be our fault." *Cyprus Mail*. 18 November 2011.
[67] Kambas, Michele. "Act now to avoid crisis, IMF warns." *Cyprus Mail*. 13 October 2011.

the expectation that the Russian creditors would have increased seniority relative to Cyprus' other creditors.

The Troika had been unwilling to manipulate seniority because of concerns over capital flight and the associated pressure on already strained capital-market spreads. So long as Russian creditor seniority was unquestioned, Moscow refrained from pressuring the Cypriot government. Over the next two years, Cyprus' situation deteriorated markedly. By 2013, with its seniority in question, Moscow refused to extend additional funds. Without an alternative source of funds, Nicosia turned to the Troika. As in the negotiations over the second Greek bailout, the IMF repeatedly expressed concerns over Cypriot debt sustainability.[68] When the ECB capitulated to IMF demands and insisted on the private-sector involvement of Cypriot banks, the Cypriot government returned to Russia as a potential creditor. Infuriated, Troika policymakers threatened to withdraw from discussions if negotiations between the Cypriot and Russian governments proceeded further.[69] On the same day that the Troika threatened withdraw, the Cypriot Parliament voted for a proposal that would impose 7%-tax on bank deposits under €100,000 and 10% on deposits over €100,000.[70] This kind of bail-in contrasted with the private-sector involvement in the Greek restructuring, in which bondholders (rather than depositors) bore the burden of adjustment. The ECB was willing to countenance such involvement for two reasons. First, as the third smallest Eurozone economy, the restructuring would cause manageable financial-market volatility, particularly because the Cypriot banking sector lacked a financial institution systematically important to the Eurozone. Second, wealthy Russians seeking a stable,

[68] "Our view: Cyprus debt sustainability complicating bailout." *Cyprus Mail*. 23 December 2012.
[69] Kambas, Michele and Karolina Tagaris. "Cyprus seeks Russian bailout aid, EU threatens cutoff." *Cyprus Mail*. 20 March 2013.
[70] "Deposit haircut back on the table." *Cyprus Mail*. 20 March 2013.

offshore banking system constituted a large proportion of relevant depositors.[71] Russian deposits appeared as a more attractive target than outstanding public-sector Cypriot debt, which was primarily held by European banks and governments. Ultimately, the deal agreed with the Troika taxed deposits over €100,000, with haircuts ranging between 40% and 60%.[72]

The Cypriot situation reflected the weak bargaining positions of small Eurozone economies, despite their representation within the Troika as part of the EC. With substantial positions in Greek debt, Cypriot banks lobbied against the private-sector restructuring of the second Greek bailout. Indeed, it was unlikely that Cyprus would have required a bailout had Greece's private-sector restructuring not taken place. Moreover, the limited engagement between Cyprus and Russia illustrated the importance of alternative external actors. Crisis countries can delay, if not eliminate, policy reform, if they can find an alternative external actor willing to extend funds. While it is outside of the bounds of this study, which runs between 2000 and 2013, in 2015, Greek politicians approached Russia as a potential source of funds in order to avoid a third Troika-financed bailout. In 2013, with the high oil prices that prevailed during Cyprus's courtship of Russia, Russian creditors were unusually willing to extend credit to a risky sovereign. In 2015, with Greece seeking similar leverage vis-à-vis the Troika, oil prices had declined sharply. As a result, while much political posturing surrounded the Greek premier's meeting with Putin, Russia extended no credit to Athens.

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[71] Buckley, Neil. "Medvedev calls for EU to rethink terms of bailout." *Financial Times*. 21 March 2013.
[72] Pantelides, Poly. "Bank of Cyprus ready to play its part says Sarris." *Cyprus Mail*. 31 March 2013.

Appendix to Chapter 5

Organization	Preference
European Central Bank	Solvency not required for disbursement; expenditure-centric (Germany)
International Monetary Fund	Solvency required for disbursement; expenditure-centric (prominent financial contributors; technocratic)
European Commission	Solvency not required for disbursement; country autonomy (set of 27 commissioners)

Table A1. Preferences of the Troika's constituent organizations. The first column lists the relevant organizations. The second column lists, first, whether solvency is required for the disbursement of funds and, second, the preference over type of adjustment. In parentheses, the primary driver of preferences is listed.

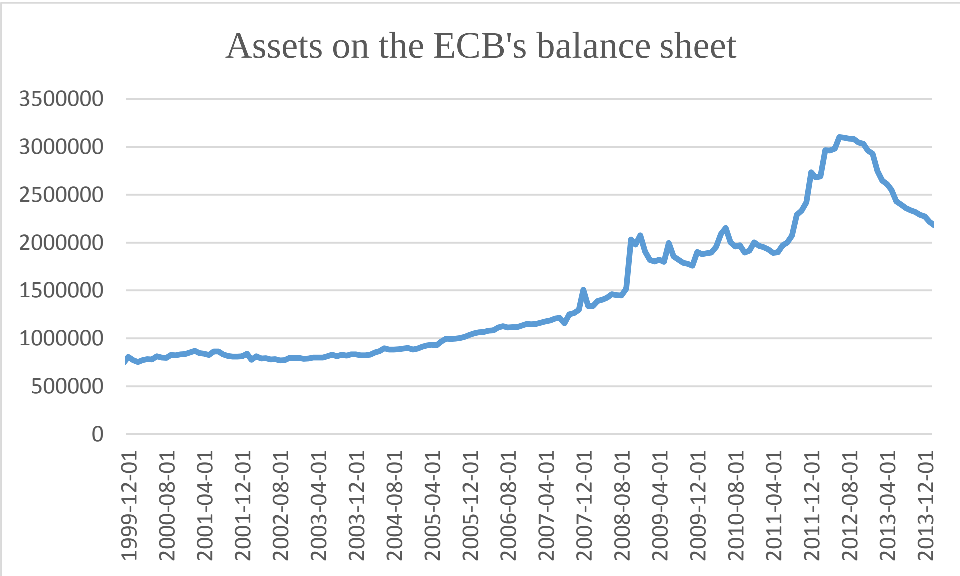

Figure A1. The value (in millions of Euros) of assets on the ECB's balance-sheet. Note the sharp increases at the onset of the financial crisis and subsequent increases with each round of LTRO. Data is taken from the European Central Bank: European Central Bank, *Central Bank Assets for Euro Area (11-19 Countries)*, retrieved from FRED, Federal Reserve Bank of St. Louis https://research.stlouisfed.org/fred2/series/ECBASSETS/, August 24, 2015.

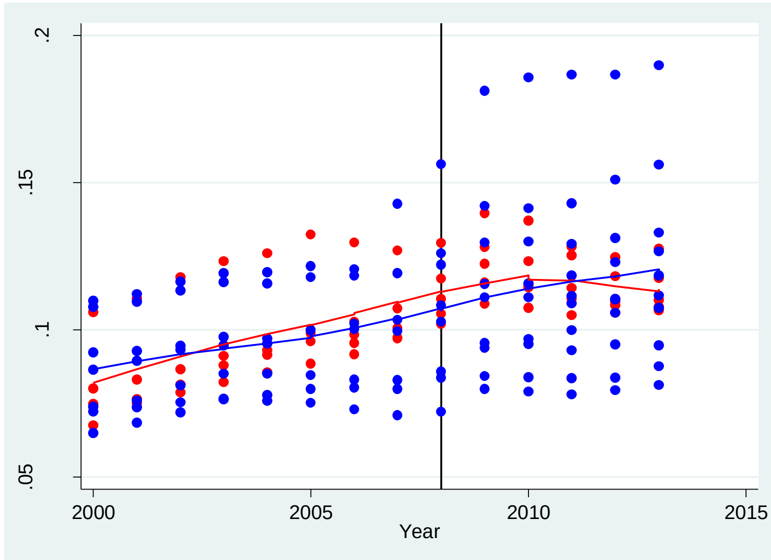

Figure A2. Public-sector compensation (as a proportion of GDP) for Eurozone countries over the study's sample between 2000 and 2013. Red dots indicate crisis countries: Portugal, Ireland, Italy, Greece, and Spain. Blue dots indicate non-crisis countries. In each panel, LOWESS regression lines with a bandwidth of 0.6 show a smoothed average of the relevant dependent variable; the red and blue lines indicate the weighted averages for crisis- and non-crisis countries, respectively.

Chapter 6: Partisanship and fiscal policy following the 2008 financial crisis

Overview of Chapters 6 & 7

The previous two chapters examined the role played by external actors in fiscal policymaking following the 2008 financial crisis. Chapters 6 & 7 turn to the domestic context and examine the roles of partisanship and consonance, respectively. The quantitative analysis in Chapter 3 employed a large-N framework to test the hybrid model presented in Chapter 1. The subsequent case studies are arranged to emphasize different elements of the proposed theoretical framework. To the extent possible, individual case studies hold constant the remaining independent variables. In Chapter 6, which examines partisanship, this means controlling for consonance and the pressure exerted by external actors; in Chapter 7, which examines consonance, this means controlling for partisanship and the pressure exerted by external actors. Looking ahead, the former juxtaposes analyses of Spain and Portugal; the latter juxtaposes analyses of Greece and Italy. The case studies emphasize variation within countries over time but also present a limited exploration of the variation between countries.

To assess the model's predictions, Chapters 6 & 7 marshal three types of evidence. First, measured policy differences, such as those presented in Figure 1, indicate the policy outcomes in different countries, under different governments, over time. Second, the two chapters present the preferences of political parties, measured with party manifestoes, in post-crisis elections. Figure 2 provides the first such example, with the RILE and MODRILE scores of the parties that participated in Spain's 2008 general election. Third and finally, the analysis relies on the coverage of the financial press to construct a political narrative. These narratives provide context for both the model's key independent variables as well as an exploration of potential confounding variables excluded from the model.

Introduction to Chapter 6

To assess the effect of shifting partisanship, Chapter 6 examines variation over time of in the policies of two countries: Spain and Portugal. In Spain, between March 2000 and March 2004, the center-right Popular Party (PP) held power in a single-party majority government. Following Al Qaeda's bombing in Madrid, three days prior to the general election, Spain's Socialist party (PSOE) formed a single-party government, which lasted until December 2011, when, following the financial crisis, the center-right PP returned to office with a single-party majority government. In Portugal, between March 2002 and February 2005, the center-right Social Democratic Party (PSD) governed in coalition with the business-conservative People's Party (CDS-PP). In 2005, the center-left Socialist Party (PS) replaced the center-right coalition government and remained in power until June 2011, when, following the financial crisis, the center-right PSD/CDS-PP reformed a coalition majority government.

In both Portugal and Spain, Chapter 6 compares policy produced under left governments with policy produced under right governments. Within each country, the model's remaining independent variable, consonance, remained constant over the sample considered. Single-party majority governments were the norm on both the left and right in Spain and the left in Portugal. On the right in Portugal, parties closely aligned on the primary cleavage of fiscal policy formed coalition governments with strong parliamentary majorities. The influence of external actors varied between the two countries, but little within the countries over time, particularly in the crisis and post-crisis periods. Since Chapter 6 relies primarily on within-country variation to draw inferences, the between-country variation in pressure applied by external actors is unproblematic. The chapter notes explicitly where variation in external pressure could drive conclusions drawn from between-country analysis.

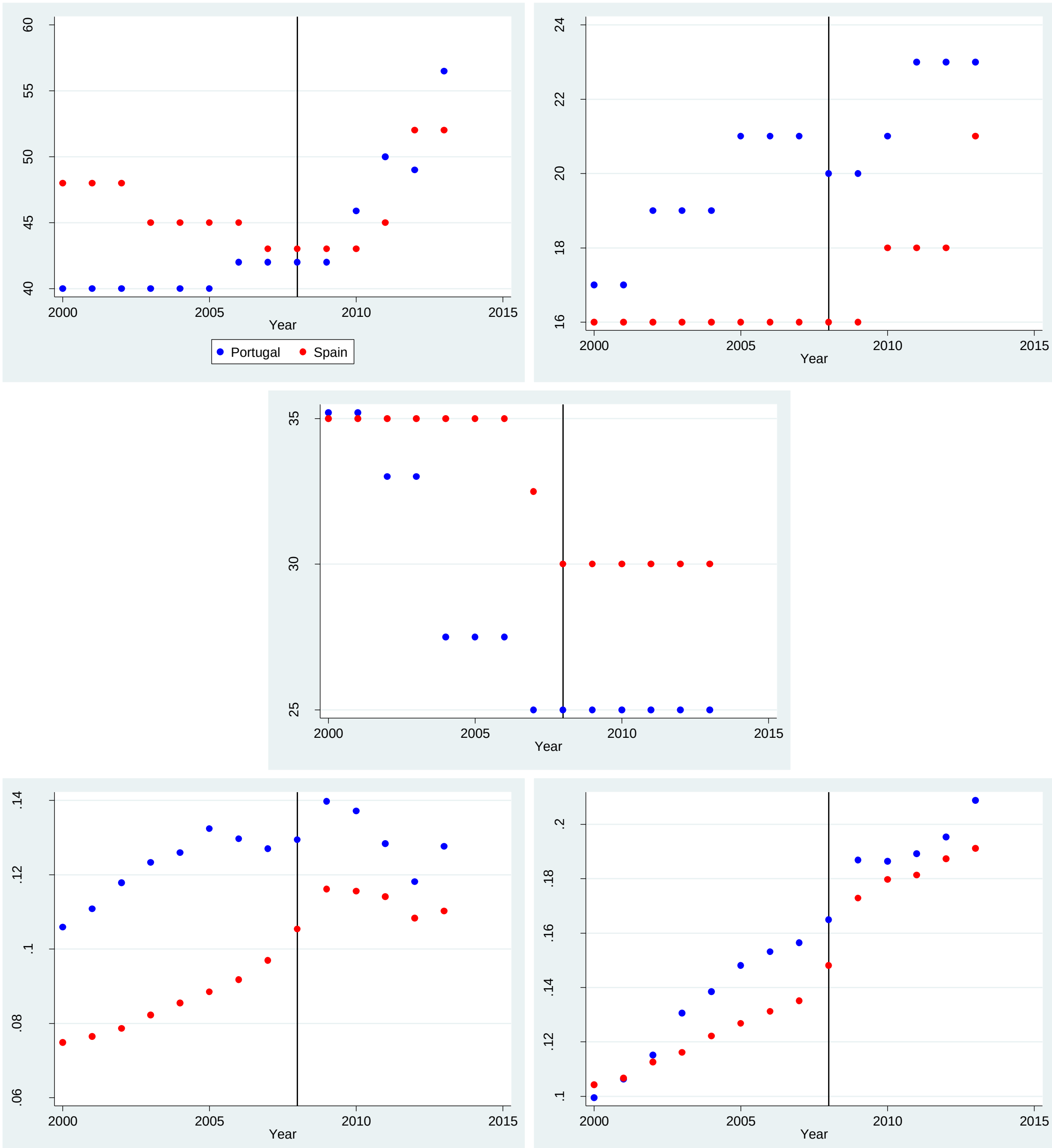

Figure 1. Disaggregated fiscal policies in Portugal (in blue) and Spain (in red) between 2000 and 2013. A vertical line at 2008 indicates the onset of the financial crisis. The top three graphs show (from left-to-right and top-to-bottom) the tax rates on income, consumption, and corporate profits, respectively. The bottom two graphs (from left-to-right) show spending on public-sector compensation and social benefits, respectively.

Spain

Between April 2004 and March 2008, the PSOE governed Spain in a single-party majority government; in the March 2008 elections, the PSOE lost its majority in parliament and transitioned to a single-party minority government. Amid rising public debt and increasing financial-market pressure to cut a growing deficit, the center-right PP replaced the PSOE in December 2011. To assess the effect of partisanship on fiscal policy, the present case study compares the policy produced following the financial crisis under PSOE with the policy produced following the PP's election.

Importantly, the alternative explanatory variables remained constant over the period under consideration. Pressure from external actors remained limited over the period, as Spain remained active in the sovereign-debt markets over the period. Moreover, as discussed in Chapter 4's bond-yield analysis and Chapter 5's exploration of external actors, external actors faced a key credibility problem with respect to the larger Eurozone economies. Whereas the Eurozone could afford to bailout smaller economies, such as Greece, Ireland, Portugal, and Cyprus, the Eurozone could not afford to let either Italy or Spain fail. Knowing this, policymakers in larger economies discounted the demands made by Troika policymakers. Because of such discounting, and because programmatic consonance remained constant over the period, fiscal-policy changes in Spain between the two governments can be primarily attributed to changes in partisanship, from the center-left Socialists to the center-right Popular Party.

Both PSOE and PP governments were single-party majority governments and thus generated the highest theoretically possible scores for consonance. There were occasions where additional support was required in the legislature. If securing such support required programmatic concessions along fiscal policy, such policy-for-vote trading complicates the dynamics of the hybrid model. In the minority PSOE administration, the government relied upon the support of small regional parties.[1] While the small regional parties had varying preferences over the different components of fiscal policy, their fiscal-policy positions, particularly those of

[1] Mallet, Victor. "Spanish austerity proposals approved." *Financial Times*. 28 May 2010.

wealthier regions, such as Catalonia, were informed by a preference for fiscal autonomy. The first subsection explores the tensions between center and periphery over autonomy and explores the implications of such tensions for Spain's post-crisis fiscal policy.

Tension between center and periphery

In May 2010, while the Troika negotiated Greece's first bailout, Spain's Socialist government announced an austerity package in an attempt to soothe financial markets. As negotiations over reform proceeded forward, a political dynamic peculiar to Spain—although present to some degree in Italy—among the crisis countries emerged as particularly salient. The importance of the autonomous regions, dating back to the political compromise between periphery and center that facilitated the transition from military dictatorship to parliamentary democracy in the 1970's, placed Madrid's government in a relatively weak position vis-à-vis its counterparts in Athens, Dublin, and Lisbon. While the proportion of spending by level of government varies from year-to-year, Madrid controls only about a quarter of the budget; the autonomous regions, responsible for health and education, spend about half of the budget with the remaining portion allocated to social security.[2] Perversely, while regions control the majority of expenditure, they control only a small proportion of taxation. This produces moral hazard that encourages regions to approve expenditure measures and pass the bill onto Madrid. Such a disconnect generates higher levels of regional expenditure in equilibrium than an institutional context that places responsibility for expenditure and taxation functions at the same level.

The tension between center and periphery created twin dynamics reminiscent of the two-level games articulated by Robert Putnam.[3] At the domestic level, on the one hand, Madrid

[2] OECD (2009), "General government expenditure by level of government", in Government at a Glance 2009, OECD Publishing. http://dx.doi.org/10.1787/9789264061651-10-en.
[3] Putnam, Robert D. "Diplomacy and domestic politics: the logic of two-level games." *International organization* 42.03 (1988): 427-460.

blamed deviations from their voters' preferred policies on the Troika. At the international level, on the other hand, Spanish governments blamed deviations from the Troika's preferred policies on the recalcitrant regions. The timing of political debates within Spain reflected the benefits potentially extracted from the Troika. In March 2012, Madrid announced measures to rein in spending by the autonomous regions.[4] Later in the month, Madrid expressed concerns about its banking system to the Troika, as described in Chapter 5's fourth vignette. When the Troika requested additional cuts and conditional reforms, Madrid argued that it was working with the autonomous regions to reduce their deficits. Without a constitutional amendment to Spain's federal fiscal structure, however, Madrid possessed no tool to credibly punish regional overshoots. Moreover, short of civil war, such an amendment would not be forthcoming. Thus, either Madrid's policymakers were being disingenuous, Brussels's myopic, or a combination of the two.

The tension between center and periphery proved important throughout the crisis, as the center attempted to reduce spending in the periphery; however, the lack of strong institutional checks sharply circumscribed the power of the center to impose fiscal reforms on the periphery. Following 2010, the ratings agencies listed the outlook for all 17 autonomous regions as "negative."[5] But with direct access to debt markets, the regions continued to borrow, with yields artificially depressed by the creditors' implicit (and, as of this writing, validated) belief that Madrid would cover the regions' debt in the case of default. Following the Troika's bailout of Ireland in November 2010, Madrid moved to assert control over the periphery by mandating

[4] Mallet, Victor. "Spain unveils toughest budget since 1970s." *Financial Times*. 31 March 2012.
[5] The autonomous regions received continuous coverage from the financial press, beginning in late 2010. Here are two representative articles from early in the press coverage: Mallet, Victor. "Cash-starved Catalonia turns to locals." *Financial Times*. & Spiro, Nicholas. "View of the Day: Nicholas Spiro, Spiro Sovereign Strategy." *Financial Times*. 16 November 2010.

quarterly updates of the financial statements of the autonomous regions. Autonomous regions that failed to comply, Madrid announced, would be unable to access debt markets.[6] The center's threat was not credible, because regions borrowed directly on debt markets, rather than through Madrid. Until Madrid demonstrated a willingness to let a region default, regions would continue to borrow freely, leaving the center to foot the bill. Catalonia, Spain's wealthiest autonomous region, publically denounced the large transfer payments required to the country's poorer autonomous regions. Artur Mas, the region's premier, failed to agree to the deficit-reduction targets set by Spain's center and privately negotiated loans with Spain's largest banks.[7] When Spain exceeded its 6% deficit target in 2011 and Madrid sought to assert increased control of the autonomous regions' budgets, Catalonia questioned the constitutionality of the measures.[8] While preparing to challenge the potential reform's constitutionality, Artur Mas also prepared measures to increase the fiscal autonomy of Catalonia.[9]

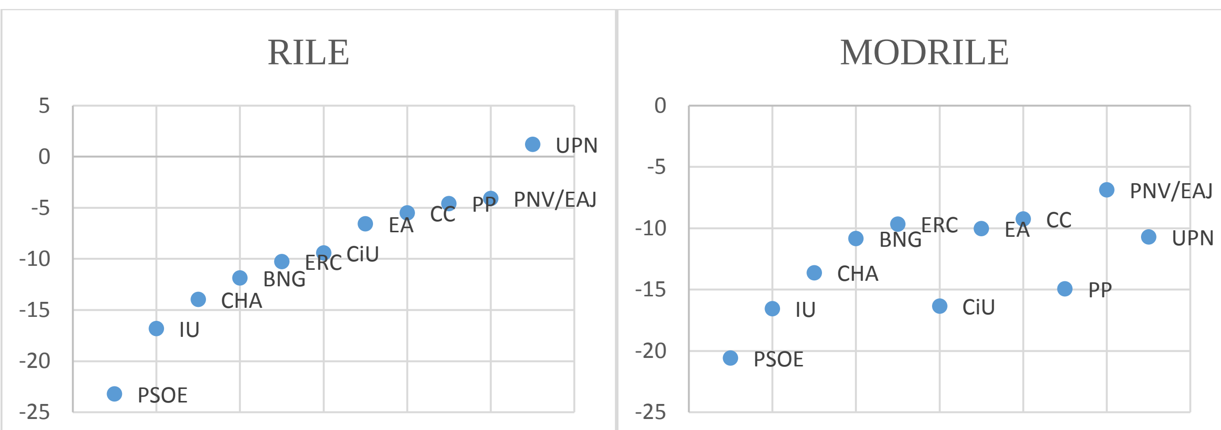

Figure 2. RILE and MODRILE scores from Spain's 2008 general election. In both graphs, parties are presented from left-to-right on the basis of their ranked RILE scores. In both panels, negative values indicate left positions, and positive values indicate right positions. Abbreviations are taken from the CMP codebook; the corresponding party names are listed in Table A1, in the appendix to this chapter.

Spain under the PSOE

[6] Mallet, Victor. "Spain curbs regions' spending." *Financial Times*. 26 November 2010.
[7] Mallet, Victor. "Catalans reject spending cuts." *Financial Times*. 29 March 2011.
[8] Mallet, Victor. "Catalonia rejects budget curbs." *Financial Times*. 6 January 2012.
[9] Mallet, Victor. "Catalonia leader seeks fiscal pact with Spain." *Financial Times*. 17 January 2012.

The March 2008 general elections in Spain pre-dated the financial crisis. While the global financial crisis did not begin until the failure of Lehman Brothers, the domestic precursors, including the bursting of asset bubbles in peripheral economies, predated the failure of Lehman Brothers, in some cases, by as many as two years. Figure A1, in the appendix to this chapter, shows the housing-price indices for the set of crisis countries, for which data was available. The figure shows the most significant property bubbles in Cyprus, Ireland, and Spain. The remaining crisis countries and Germany exhibited little, if any, pre-crisis increase in housing prices. In the cases of Ireland and Spain, the property bubbles burst prior to the failure of Lehman Brothers; thus, the financial-crisis conditions that characterized the post-crisis period in other crisis countries appeared in Ireland and Spain, albeit in a milder form, between the middle of 2007 and early 2008.

Because of the conditions in the Spanish property market, the financial-market conditions in Spain's March 2008 election approximated those in post-crisis election. The left-hand-side panel of Figure 2 displays the RILE measures, taken directly from the CMP. The right-hand-side panel extracts the economic components from RILE to produce MODRILE. The contrast between RILE and MODRILE suggests that much of the variation between Spain's parties involves non-economic components; the strong regional preferences of many Spanish parties provides a political logic underlying the observed divergence in measures. Indeed, four parties defined by regionalist, if not secessionist, objectives—CiU, EA, CC, and UPN[10]—exhibit the largest changes between RILE and MODRILE scores. When measured in the RILE space, the two mainstream parties—PP and PSOE—are situated opposite one another; the intervening political space shrinks in the MODRILE space. The 2011 budget, organized against the backdrop

[10] The names of these parties, listed in Table A1, reveal the regional basis for these parties: Convergence and Union (a Catalan independence party), Basque Solidarity, Canarian Coalition, and Navarrese People's Union.

of Greece's deteriorating financial situation and increasing bond spreads across the Eurozone's periphery, shows how the divergent political preferences of Figure 2 manifest in public policy and associated debate.

With bond yields on Spanish debt increasing in the first half of 2010, the Socialist government faced increasing financial-market pressure to implement reforms.[11] The austerity package proposed in 2010 imposed reductions in public-sector pay and pensions, in addition to cuts in broader social spending.[12] The conservative PP largely applauded such cuts, while noting, in some cases, that they did not go far enough. With respect to taxation, the PSOE announced increases in the tax rates of high-income individuals.[13] Figure 1 shows a two-point increase in Spain's top marginal tax rate. In addition, in September 2010 negotiations over the 2011 budget, the government announced increased taxation of capital gains, causing further anger within the PP's ranks.[14] The PP strongly opposed the increased tax burden proposed in the 2011 budget; this burden was particularly galling to the PP, given its targeting of key component PP constituencies. The parliamentary vote on the 2011 budget reflected the schism between mainstream parties. To consolidate support among its parliamentary allies and to secure the support of key regional parties, the government restored €500 million in public investment that had been cut as part of the May 2010 austerity package.[15] The plan passed the Spanish parliament by only a single vote with extensive debate between the left, the right, and regional parties.[16] Without the support of regional parties, given the PSOE's minority position, the proposed budget would not have passed. The 2011 budget indicates why the stark predictions

[11] Mallet, Victor and Peter Wise. "Spain and Portugal under strain." *Financial Times*. 6 February 2010.
[12] Mallet, Victor. "Spain deepens its austerity drive." *Financial Times*. 13 May 2010.
[13] Mallet, Victor. "Spain reveals new tax on the rich." *Financial Times*. 27 May 2010.
[14] Mallet, Victor. "Tax rise on rich in Spain's 'austere' 2011 budget." *Financial Times*. 25 September 2010.
[15] Mallet, Victor. "Madrid restores €500m spending on infrastructure." *Financial Times*. 19 August 2010.
[16] Mallet, Victor. "Spanish austerity proposals approved." *Financial Times*. 28 May 2010.

that emerge from the partisan MR model are misleading. The two mainstream parties agreed on significant portions of the budget, particularly those related to cuts in public-sector compensation. Such agreement did not prevent vigorous parliamentary debate, which gave rise to the impression that the government and opposition disagreed on all points.

In the wake of the passage of the austerity package, financial markets continued to apply pressure on Spanish bond yields and rating agencies downgraded Spanish debt.[17] In April 2011, Jose Zapatero announced that he would resign as the PSOE party leader prior to the general election, scheduled for March 2012.[18] In July 2011, Zapatero brought forward the general election to November 2011.[19] In September 2011, the PSOE introduced a wealth tax in Parliament, intended to target the country's million wealthiest individuals.[20] Much to the PP's consternation, this resulted in the large increase in income-tax rate observed between 2011 and 2012 in Figure 1; this increase came on top of the increase legislated in the 2011 budget. Notwithstanding the vituperative debate over the 2011 budget, the opposition displayed a willingness to work with the government, even after the announcement of general elections, if the proposed legislation aligned with the PP's constituency. This cooperation become important when, following the passage of the Fiscal Compact in March 2012, the Troika required that Eurozone member states incorporate the SGP's debt and deficit limits domestically, either as statute or as constitutional amendment. With strong support from both the opposition PP and the Troika, the PSOE passed a balanced-budget amendment to Spain's constitution.[21]

[17] Mallet, Victor and Jennifer Hughes. "Euro falls as agency cuts Spain debt rating." *Financial Times*. 29 May 2010.
[18] Mallet, Victor. "Spain's Zapatero to stand down at election." *Financial Times*. 4 April 2011.
[19] Johnson, Miles. "Zapatero calls early Spanish general election." *Financial Times*. 30 July 2011.
[20] Mallet, Victor. "Spanish Socialists revive wealth tax plan in effort to calm markets." *Financial Times*. 14 September 2011.
[21] "The golden amendment." *The Economist*. 3 September 2011.

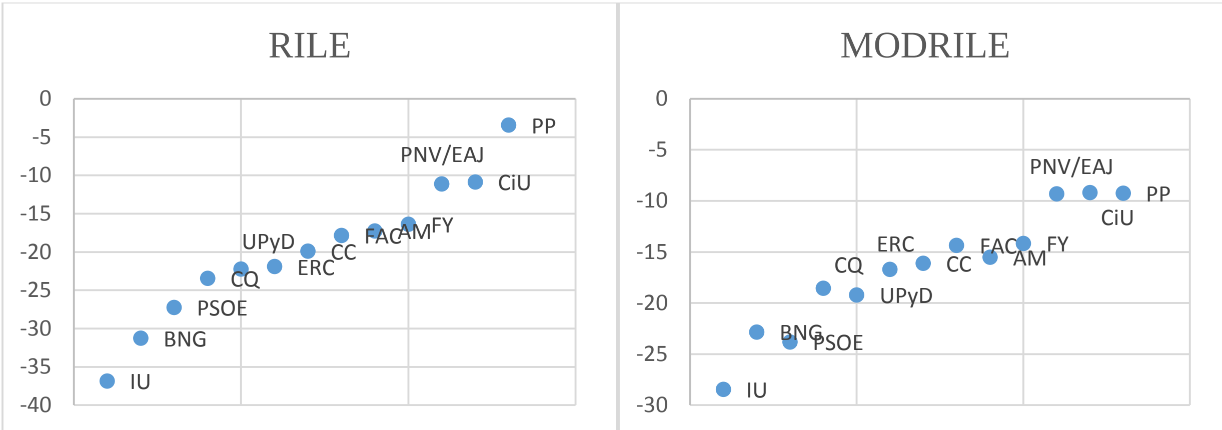

Figure 3. RILE and MODRILE scores from Spain's 2011 general election. In both graphs, parties are presented from left-to-right on the basis of their ranked RILE scores. In both panels, negative values indicate left positions, and positive values indicate right positions. Abbreviations are taken from the CMP codebook; the corresponding party names are listed in Table A1, in the appendix to this chapter.

A shift to the right: Spain under the PP

In Spain's 2011 general election, in contrast to the 2008 general election, as shown in Figure 3, the MODRILE ranking largely preserved the RILE order. This reflected the ascendance of economic policy as the dominant cleavage, occluding the regional impulse that shaped party preferences in prior elections. As the economic space provided the primary context for electoral competition, the two parties situated themselves at opposite sides of the political spectrum. This contrasts with the relative similarity in economic positions adopted by the PP and the PSOE in the 2008 elections, as shown in Figure 2. The opening up of the economic ideological space in Spain contrasts with the ideological convergence in Greece, Ireland, and Portugal over the sample period. This discrepancy reflects the differences in financial-market pressure over the crisis countries, a discrepancy accounted for in the hybrid model but not in any of the three dominant contemporary approaches. In the November election, the Popular Party won a majority of seats in the Spanish parliament and created a single-party majority government. Figure 2's divergent preferences manifested in policy debates following the election. After entering government in December 2011, the center-right government announced a 2011 deficit of 8%, two percentage points in excess of the 6% target brokered between the former PSOE government and the Troika.[22] The incoming government blamed the former administration both for failing to close the deficit and for failing to disclose the degree of departure from the target. In response, the new government announced additional austerity measures, including extensive public-sector cuts; the measures avoided the income-tax heavy approach adopted by the prior government.[23] Figure 1 shows the largest decline in Spain's public-sector compensation over the sample between 2011 and 2012.

In February 2012, the new government lobbied the Troika to reduce the 4.4% deficit target for 2012. In step with the IMF's evolving position, examined in Chapter 5's second vignette, Spanish politicians expressed concerns over the growth-stinting effects of the cuts required to achieve the 2012 target.[24] Politicians in Greece and Portugal expressed similar concerns over the austerity packages negotiated with the Troika. However, unlike with the three smaller Eurozone economies, the Troika granted significant concessions to Spain. Concessions came in two primary forms: relaxed deficit targets and unconditional financial aid with respect to Spain's failing banks. In March 2012, the Troika relaxed the 4.4% deficit target for 2012 to 5.3% after Rajoy's government unilaterally announced a target of 5.8% of GDP.[25] In July 2012, the Troika further relaxed Spain's deficit target, raising the 2012 target to 6.3% and pushing the 3% target to 2015.[26]

By May 2012, with two years of austerity accomplished, Spanish banks began announcing large losses. Experts estimated the funds required to recapitalize the troubled banks

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[22] Mallet, Victor. "Spain warns of deficit overshoot." *Financial Times*. 31 December 2011. Subsequent data led to an upward revision of the 2011 deficit to 8.51% of GDP (Mallet, Victor. "Spain overshoots EU budget deficit target despite cuts." *Financial Times*. 28 February 2012).

[23] Mallet, Victor. "Spain issues fresh deficit alert." *Financial Times*. 3 January 2012.

[24] Mallet, Victor. "Spain pushes Brussels to cut deficit target as growth hopes are dashed." *Financial Times*. 24 February 2012.

[25] Mallet, Victor and Peter Spiegel. "Spain hails budget deal as victory despite need for €5bn in extra cuts." *Financial Times*. 14 March 2012.

[26] Johnson, Miles and Peter Spiegel. "EU to relax Spain deficit targets." *Financial Times*. 10 July 2012.

ranged between €50 billion and €200 billion. Rajoy's government turned to the Troika to help fill the gaping hole. Initially, the Troika required extensive fiscal adjustment as a necessary condition for Spain's receipt of Troika funds. In May 2012, Commissioner for Economic and Monetary Affairs Olli Rehn offered to extend the 3% deficit target from 2013 to 2014 in exchange for credible adjustment measures. Madrid, however, brazenly rejected the extension and, at the same time, acknowledged that it would not be able to recapitalize its hemorrhaging banking sector.[27] Through the end of May and early June, Madrid resisted the Troika's repeated entreaties to enter a formal bailout framework, which would require that Madrid to submit to the quarterly visits and policy concessions present in Greece, Ireland, and Portugal. Madrid forced the Troika's hand by continuing to issue sovereign bonds, despite their plunging prices and rising yields.[28] The Troika[29] eventually capitulated, agreeing to extend €100 billion to Spanish banks directly in return for Spain's implementing austerity measures previously agreed upon. Crucially, the Troika required the implementation of no further austerity measures.[30] In July 2012, with Spain and Italy pushing for further concessions from the Troika, the summer's Eurozone Summit produced two important policy results: direct recapitalization of Eurozone banks, rather than indirectly through target governments, as well as €120 billion in measures to promote growth.[31] Chapter 5 traced the eventual backtracking from these positions that occurred as Northern politicians interacted with their domestic constituencies.

All of this is not to say that financial markets exerted no pressure on Madrid's policymakers, only that these pressures paled in comparison to those faced by policymakers in

[27] Spiegel, Peter and Ralph Atkins. "EU offers to extend Spanish deadline." *Financial Times*. 31 May 2012.
[28] Mallet, Victor, Johnson, Miles and Peter Spiegel. "Defiant Spain angers troika by striving to avoid formal rescue." *Financial Times*. 2 June 2012.
[29] The Troika was technically not responsible for the recapitalization, since under the terms of the IMF's charter, it cannot participate in pure bailouts of financial sectors. Thus, funds came exclusively from the EFSF and the ESM.
[30] Spiegel, Peter. "Q&A: Madrid's rescue will differ from previous interventions." *Financial Times*. 11 June 2012.
[31] Wolf, Peter. "A step at last in the right direction." *Financial Times*. 4 July 2012.

Athens, Dublin, and Lisbon. Moreover, when Rajoy implemented adjustment measures following the bailout of Spanish banks, his government's policies took on a more partisan flavor. Rajoy's austerity package, included as part of the 2012 budget, increased consumption taxes by three percentage points, shown in Figure 1 between 2012 and 2013, and reduced unemployment benefits.[32] Against the backdrop of increased consumption taxes and reduced expenditure, corporate tax rates remained constant. The terms of the domestic adjustment debate, however, continued to be circumscribed by Spain's strong position vis-à-vis the Troika. The PP-government implemented limited tax changes, in line with the preferences of its constituencies. This position of strength, shared by Italy, stands in contrast to the relatively weak positions of Portugal (examined here in the next section) and Greece (examined in Chapter 7).

Portugal

The Portuguese case shares similarities and highlights differences with the Spanish case. As in the Spanish case, consonance remains relatively constant across the governments in question. Portugal's Socialists Party (PS) governed as a single-party majority government between February 2005 and September 2009. After losing their parliamentary majority in September 2009, the Socialists transitioned into as a single-party minority government until June 2011, when the center-right Social Democrats (PSD) entered office. The Social Democrats' partner party, the conservative People's Party was closely aligned with the Social Democrats on fiscal policy and thus generated effectively the same level of consonance as in the prior single-party PS governments.

The primary difference between the Portuguese and Spanish cases involved the pressure applied by external actors. In the Spanish case, Troika pressure on Spanish policymakers was not

[32] Johnson, Miles. "Protests as Spain steps up cuts." *Financial Times*. 12 July 2012.

credible because Spain was “too-large-to-fail.” With respect to Portugal, Troika policymakers could countenance the economy’s failure. In the Portuguese environment, the hybrid model suggests that the partisan differences between mainstream parties should converge and more closely reflect the preferences of external actors than in cases similar to Spain’s, with less credible external-actor pressure. Thus, whereas the model predicts significant differences in Spanish policy between socialist and conservative regimes in response to minimal external pressure, the model predicts limited differences between the policy outputs in Portugal under socialist and conservative regimes. The Socialist Prime Minister Jose Socrates expressed the implications of bond-market pressure when he announced that he had “no alternative” but to freeze pensions and cut public-sector wages in the two austerity packages announced in 2010.[33] As the head of a socialist party, the freezes and cuts mandated by Socrates threatened the party’s core public-sector constituency. As Figure 1 shows, the steep decline in public-sector compensation between 2009 and 2012 has no analog in the Spanish context, where the PSOE was better able to protect its core constituency.

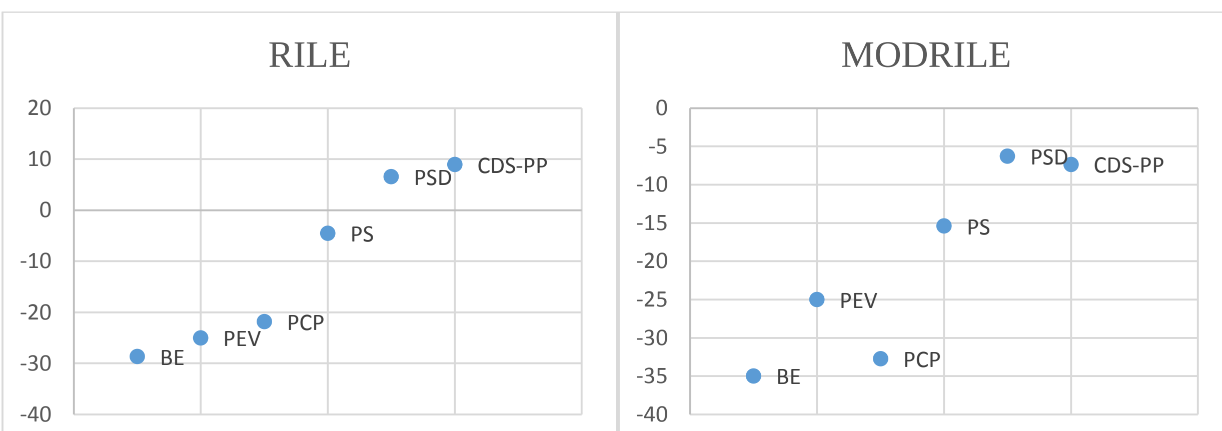

Figure 4. RILE and MODRILE scores from Portugal’s 2009 general election. In both graphs, parties are presented from left-to-right on the basis of their ranked RILE scores. In both panels, negative values indicate left positions, and positive values indicate right positions. Abbreviations are taken from the CMP codebook; the corresponding party names are listed in Table A2, in the appendix to this chapter.

[33] Wise, Peter. “Portugal had ‘no option’ on cuts.” *Financial Times*. 2 October 2010.

Portugal under the PS

The hybrid model suggests that policy convergence should be observed between mainstream parties in restrictive bond-yield environments. Prior to the September 2009 general elections, the PS controlled a majority of seats in parliament. The 2009 general election took place against the backdrop of increasing bond spreads. Despite the wide variation in RILE scores over the party space, the two mainstream parties are adjacent to one another. In the MODRILE space, the PS is adjacent to the PSD's conservative coalition partner, CDS-PP. The ideological compression observed with respect to Portugal's mainstream parties relative to Spain's reflects the pressure applied by financial markets and external actors and supports a key element of Chapter 1's hybrid model. While the Socialists formed a minority government following the September 2009 election, the subsequent two austerity budgets reflected their lack of domestic political autonomy. Moreover, the timing of these budgets—the first immediately following the first Greek bailout and the second narrowly predating the Irish bailout—underscores the importance of contagion and the relevance of external actors to policymaking in Lisbon. The first austerity package reduced the pay of senior public servants and increased income, corporate, and consumption taxes.[34] Crucially, from the perspective of the PS, the first austerity package protected the pay of the majority of the public sector.

Following the announcement of the first round of austerity measures in July 2010, Portuguese bond yields continued to increase, leading financial-market observers to question whether Portugal would require a bailout.[35] Ratings firms intensified the pressure by reducing Portugal's sovereign-debt rating.[36] This pressure continued to intensify, as the Troika entered

[34] Wise, Peter. "Crisis tax on wages and profits as Portugal swings austerity axe." *Financial Times*. 14 May 2010.
[35] Oakley, David. "Portugal's debt auction raises EU aid concern." *Financial Times*. 10 June 2010.
[36] Wise, Peter. "Portugal's bond ratings cut." *Financial Times*. 14 July 2010.

negotiations with Ireland in late 2010. In September 2010, the second austerity package reduced public-sector wages and further raised consumption-tax rates.[37] In contrast to the first package, the second unambiguously hurt one of the party's core constituencies: the public-sector employee. The limited partisan debate over the substance of the austerity packages involved the insistence by the Social Democrats that more of burden be shifted to spending cuts rather than tax increases.[38] Such debates, however, did not prevent the passage of the government's budget, which incorporated the two austerity packages, in November 2010. At the last minute, the Social Democrats abstained from the vote, allowing the minority Socialists to pass the budget.[39]

The Troika, however, advocated further cuts by Lisbon's government. Olli Rhen stressed the importance of further reforms for Portugal's recovery following the Irish bailout.[40] As the pressure to cut intensified, agencies repeatedly cut the rating of Portugal's sovereign debt.[41] As bond yields continued to climb, international observers and domestic politicians recognized the impending need for financial assistance. Amid increasingly restrictive conditions, the Socialists again targeted their core constituencies with additional proposed cuts to state pensions, healthcare spending, unemployment insurance, and welfare benefits.[42] In contrast to what a partisan MR model would predict, the Social Democrats defeated the proposed measures, leading to Socrates' resignation and a snap election.[43] While the PSD's leadership framed the parliamentary defeat in terms of substantive policy differences, their subsequent actions suggested that the move reflected political opportunism, rather than policy differences. In the

[37] Wise, Peter. "Lisbon unveils new austerity plan." *Financial Times*. 30 September 2010.
[38] Wise, Peter. "Portugal under pressure on deficit target." *Financial Times*. 22 October 2010.
[39] Wise, Peter. "Late pact to pass austerity budget buys Portugal time." *Financial Times*. 1 November 2010.
[40] Wise, Peter and Joshua Chaffin. "Commission warns Lisbon on further austerity." *Financial Times*. 30 November 2010.
[41] Wise, Peter. "Fitch lowers Lisbon's credit status." *Financial Times*. 24 December 2010.
[42] Peel, Quentin and Peter Wise. "Lisbon pledge more cuts." *Financial Times*. 12 March 2011.
[43] Smith, Stephen. "Portugal vote puts investors on the defensive." *Financial Times*. 24 March 2011.

weeks that followed, the Social Democrats did not present alternative measures to close the deficit. Moreover, when it eventually entered office in June 2011, the PSD's policies implemented did not differ in substance from those vetoed in March 2011.

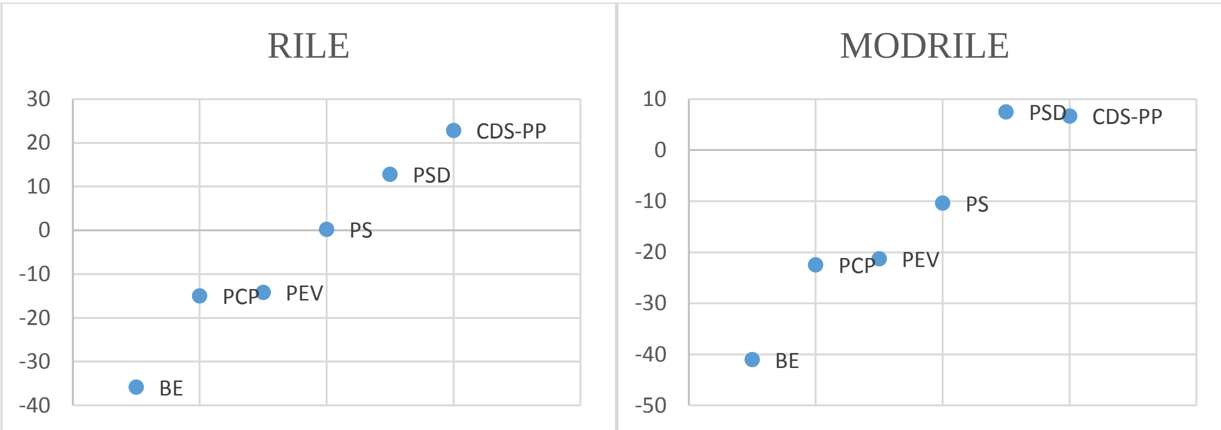

Figure 5. RILE and MODRILE scores from Portugal's 2011 general election. In both graphs, parties are presented from left-to-right on the basis of their ranked RILE scores. In both panels, negative values indicate left positions, and positive values indicate right positions. Abbreviations are taken from the CMP codebook; the corresponding party names are listed in Table A2, in the appendix to this chapter.

A shift to the right: Portugal under the PSD/CDS-PP

In 2011, as in 2009, the preferences of political parties reflected the ideological compression observed in the prior bargaining over austerity packages. As in the 2009 election, the three potential governing parties were adjacent to one another in the RILE space. In the MODRILE space, while the expressed differences between left and right governing parties intensified, they remained adjacent to one another. The joint negotiations that preceded the Troika's bailout reflected the convergence in policy positions adopted by the mainstream parties both before and after the June 2011 elections. In April 2011, as electoral competition between the Socialists and Social Democrats escalated, the parties' leaders agreed to cooperate over bailout negotiations that would precede the elections.[44] In May 2011, the two party leaders agreed to terms with the Troika for a three-year, €78 billion bailout. In exchange for funds,

[44] Wise, Peter. "Portugal's rivals put bail-out before poll fight." *Financial Times*. 8 April 2011.

Portugal agreed to freeze public-sector pay and pensions until 2013 and imposed additional taxes on pensions in excess of €1500 per month.[45] In the month between the end of the bailout negotiations and the snap election, the opposition Social Democrats proposed a number of growth-friendly tax measures, including cutting employer social-security contributions.[46]

In June 2011, the opposition Social Democrats secured a majority of seats in Portugal's parliament.[47] Despite the renewed hope in Lisbon following the election, agencies continued to cut the rating of Portugal's sovereign debt amid concerns over the growth implications of anticipated austerity measures.[48] In September 2011, the government announced its proposed austerity budget, which included a public-sector wage freeze through 2013, a reduction in the level of public-sector employment, and an increase in the taxation of corporate earnings and wealthy individuals.[49] In October 2011, additional details emerged, including cuts to spending on healthcare and education and an increase in consumption taxes.[50] Thus, ironically, by the end of 2011, the budget proposed by the Social Democrats appeared similar to that rejected by the same Social Democrats six months earlier in March 2011. The similarity of the two budgets reflected the programmatic convergence predicted by the hybrid model.

Portugal's institutional peculiarity

Whereas the tension between center and periphery rendered Spain unique among crisis countries, Portugal's Constitutional Court played a crucial role in shaping post-crisis adjustment policy. The idiosyncratic impact of the Court, like the influence of Spain's autonomous regions, falls outside the scope of a model seeking to generalize about fiscal policymaking across a wide

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[45] Wise, Peter. "Portugal faces pain in spite of rescue." *Financial Times*. 5 May 2011.
[46] Wise, Peter. "Portugal poll rivals clash on economy." *Financial Times*. 20 May 2011.
[47] "Life after Socrates. Passos Coelho must make the case for Portuguese reforms." *Financial Times*. 7 June 2011.
[48] Wise, Peter; Spiegel, Peter and Ben Hall. "Downgrade blow knocks wind out of Portugal." *Financial Times*. 7 July 2011.
[49] Wise, Peter. "Portugal brings in austerity measures 'without precedent'." *Financial Times*. 1 September 2011.
[50] Wise, Peter. "Lisbon tried to avert 'national emergency'; Austerity measures." *Financial Times*. 14 October 2011.

set of countries. That said, a discussion of Portugal's post-crisis fiscal policy would be not be complete without addressing the obstinacy of the Constitutional Court, whose role both domestic and international actors overlooked prior to its surprising entrance onto the fiscal stage. As part of the first austerity packaged described above, adopted in the first year of the three-year bailout program agreed to with the Troika, Lisbon eliminated holiday bonuses awarded to the public sector. The Constitutional Court, however, declared these measures unconstitutional. In place of the public-sector cuts, the center-right government proposed wealth and corporate taxes.[51] Thus, the intercession of the Constitutional Court shifted the onus of adjustment from the opposition's core constituency, the public sector, onto the government's core constituency, the middle class and corporate interests. In April 2013, in the second year of the bailout program, the Court declared unconstitutional cuts to state pensions and public-sector wages. Economists valued these cuts at roughly 7% of take-home pay for public-sector employees. In their stead, the government committed to additional cuts on social benefits that did not specifically target public-sector employees.[52] In a final flurry of activity, the Court declared unconstitutional legislation related to the hiring, firing, and wages of public-sector employees.[53] In each of these cases, the Court took issue with legislations' asymmetric treatment of the private- and public-sectors. The Court declared discriminatory, and therefore unconstitutional, any measure that applied only the public sector. The economic justification of such a move is questionable. If Portuguese public-sector employees were particularly underpaid relative to their private-sector counterparts, the Court's decision would produce an economically rational outcome. However, the public-to-private wage ratio, about 1.5—after controlling for relevant characteristics such as education and

[51] Wise, Peter. "Portugal unveils fresh austerity plan." *Financial Times*. 8 September 2012.
[52] Wise, Peter. "Portugal's austerity steps ruled illegal." *Financial Times*. 6 April 2013.
[53] Wise, Peter. "EU to fight Lisbon on easing targets." *Financial Times*. 16 September 2013.

experience—in Portugal is among the highest in the Eurozone.[54] To economists' chagrin, political parties and judicial institutions operate according to political, rather than economic, logic.[55] Importantly, for the context of the hybrid model, the wage disparity had increased since Portugal's accession to the Euro, following which the government consolidated a core constituency by financing higher public-sector salaries with cheap money on sovereign-debt markets.

The relevance of Portugal's Constitutional Court, like that of the tension between Spain's center and periphery, to post-crisis fiscal policy provides an important caveat with respect to generalizable explanations for complicated sociopolitical phenomenon. No explanation for a wide set of countries can explain all variation in both process and outcome. Short of applying elaborate scope conditions that effectively eliminate generalizability, models invariably ignore important variables. In this vein, the hybrid model seeks not to explain all variation in fiscal policy over the sample period. Instead, the model seeks to capture a significant portion; whether that amount is deemed sufficient ultimately depends on the modeler's preferences and purposes.

Portugal, Spain, and the implications for the hybrid model

The juxtaposition of the Spanish and Portuguese cases reveals the importance of a hybrid model that incorporates both international and domestic factors. With respect to international factors, the variation in pressure applied by financial markets explained the relative influence of external actors in the domestic policy of the two crisis countries. As detailed in the time series of Chapter 3, the initial response of both Portuguese and Spanish policymakers was expansionary.

[54] Giordano, Raffaela, et al. "The public sector pay gap in a selection of Euro area countries." (2011).
[55] Interestingly, the emergence of the Constitutional Court as a prominent player on Portugal's political scene may explain the limited fracturing of Portugal's electoral landscape compared with other crisis countries. Against the backdrop of a seemingly impervious Troika, anti-European, anti-establishment parties rose to prominence in other crisis countries. *Inter alia*, these include Podemos and Ciudadanos (in Spain), Syriza in Greece, and the Five Star Movement in Italy. By providing a counterpoint to Troika policy, it is possible that the Constitutional Court preserved Portugal's electoral landscape.

Beginning in the middle of 2009, when bond yields began to price in country-specific, sovereign debt risk, the financial-market pressure, and therefore influence of external actors in crisis countries, diverged. In Spain, where bond yields remained relatively close to the German bund, policymakers were relatively insulated from the demands of external actors. Moreover, Spain's position as one of the Eurozone's four largest economies, introduced credibility problems with respect to the Troika. Financial-market observers, and Madrid's policymakers, bet that Brussels would not allow Spain to default. Madrid's negotiations of unconditional aid for its banks at the Eurozone Summit in the summer of 2012 attest to Spain's strong bargaining position vis-à-vis the Troika. From such a position of strength, policies promulgated by Rajoy's government reflected the government's partisan preferences to a far greater extent than those adopted under Coelho's PSD-led government in Lisbon. Lisbon, in contrast to Madrid, possessed little leverage with the Troika. Lisbon's ability to extract concessions was limited to the period in which salient divisions emerged within the Troika, which date roughly to Christine Lagarde's taking over as Managing Director in June 2011. The consequent space for maneuver was limited and occurred after Lisbon had brokered a three-year plan with the Troika in May 2011.

Even in Portugal, however, where external actors sharply circumscribed the policy space available to domestic politicians, domestic politics influenced fiscal-policy outcomes. Thus, a fully international model based upon the convergence approach, would elide important features of the Eurozone's post-crisis fiscal policy. In Portugal, the hybrid model's domestic component helps to explain why the Socialist government's first austerity package employed primarily tax increases with little direct effect on the party's core constituency: the public-sector employee. The pressure of financial-markets, and thus the international dimension, helps to explain why subsequent packages adopted by the socialist government included widespread cuts to the public sector. The domestic dimension of the hybrid model, however, is more important in countries where financial-market conditions limit the influence of external actors in domestic policymaking. While bond yields in Spain increased significantly above German bunds early in the post-crisis period, they remained far below those of the smaller crisis countries. These relatively relaxed financial conditions permitted Spanish policymakers more autonomy with which to design austerity measures. Such autonomy is most apparent following the bank bailout negotiated with the Troika, after which, Rajoy's government implemented limited cuts that targeted the opposition's core constituencies.

Appendix to Chapter 6

Abbreviation	Party name (in English)
IU	United Left
BNG	Galician Nationalist Bloc
PSOE	Spanish Socialist Workers' Party
CQ	Commitment-Q
UPyD	Union, Progress and Democracy
ERC	Catalan Republic Left
CC	Canarian Coalition
FAC	Forum Asturias
AM	Amaiur
FY	Future Yes
PNV/ENJ	Basque Nationalist Party
CiU	Convergence and Union
PP	Popular Party
CHA	Aragonist Council
EA	Basque Solidarity
UPN	Navarrese People's Union

Table A1. Party abbreviations and full party names from Spain's 2011 elections translated into English, according to the CMP. Parties are listed in their ranked RILE, starting with the leftmost party at the top. Three parties below the black cells participated in the 2008 but not the 2011 general elections.

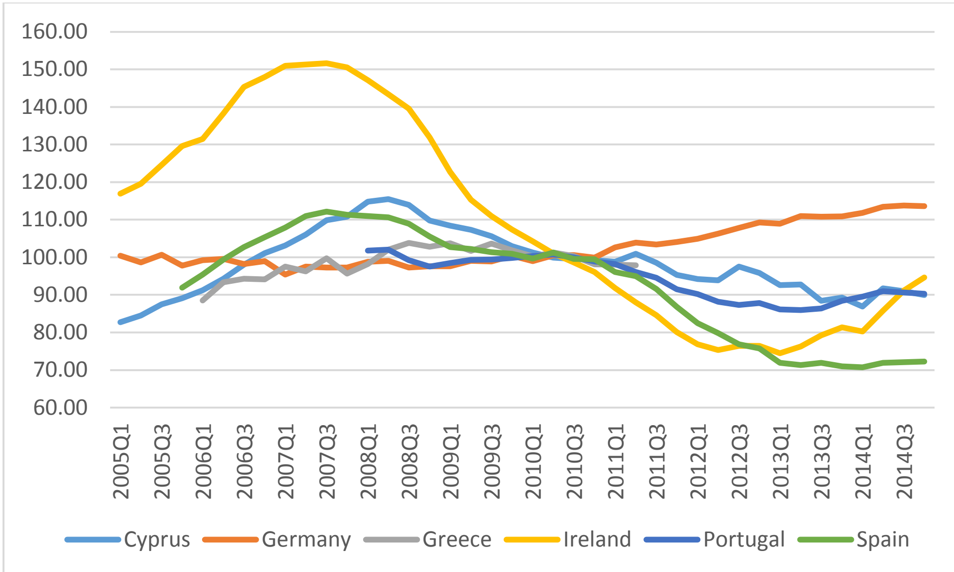


Figure A1. Housing-price indices for the set of crisis countries for which data was available. Germany is included for reference. Data was taken from Eurostat's Statistical Data Warehouse.

Abbreviation	Party name (in English)
BE	Left Bloc
PEV	Ecologist Party, "The Greens"
PCP	Portuguese Communist Party
PS	Socialist Party
PSD	Social Democratic Party
CDS-PP	Social Democratic Center-Popular Party

Table A2. Party abbreviations and full party names from Portugal's 2009 and 2011 elections translated into English, according to the CMP. Parties are listed according to their ranked RILE scores in 2009, starting with the leftmost party at the top. In 2011, PEV and PCP switched spots, with PCP to the left of PEV.

Chapter 7: Consonance and fiscal policy following the 2008 financial crisis

Introduction

Empirically evaluating the role of consonance is more problematic than the role of partisanship, primarily because of the relationship between consonance and the hybrid model's remaining two independent variables (external actors and partisanship). For reference, Equation 1, which reproduces Equation 1 from Chapter 2, shows how consonance is calculated.

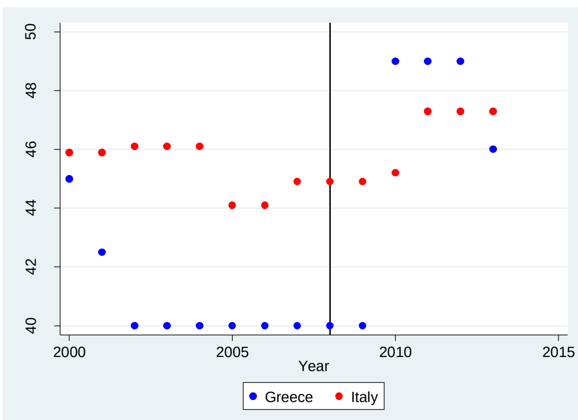
$$\boldsymbol{C = 1 - (Rank_{High} - Rank_{Low})/Max(Rank)} \qquad (\textit{Equation 1})$$

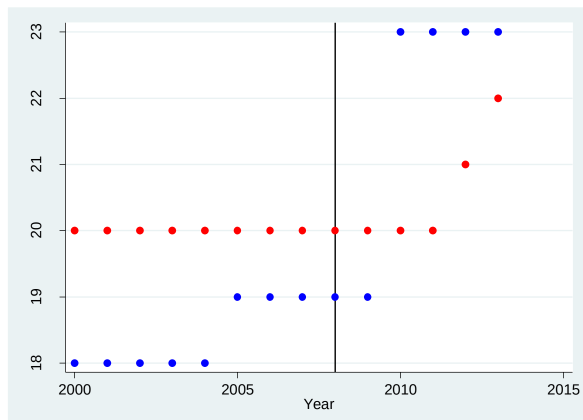
Equation 1 shows that there are two means by which to change consonance. First, the MODRILE rank of either party can change, as reflected in the numerator. Second, with respect to the denominator, a shift in the number of parties changes consonance. From the perspective of separately identifying the effects of partisanship and consonance on fiscal policy, these conditions have a problematic implication. A shift in consonance requires, by definition, a change in the partisanship of a government.[1] As a result, to evaluate the effect of a change in consonance, the chapter tracks the experience of individual parties in governments that differ in their level of consonance. In doing so, the chapter explores how changes in consonance influence the role of particular parties and thereby drives the mix of fiscal policies produced.

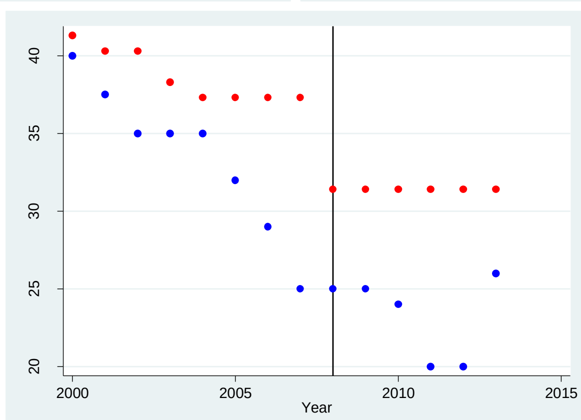
The chapter is divided into two case studies. The first examines the post-crisis politics of Greece; the second examines the post-crisis politics of Italy. The first case study compares PASOK's role as the sole member of a single-party government between October 2009 and November 2011 with PASOK's role as a member of a grand coalition between June 2012 and January 2015. The second case study compares People of Liberty's (PDL's) role in the center-

[1] Note that the converse is not necessarily true. A change in partisanship does not require a change in consonance, as occurs when single-party governments, representing different ideological positions, replace one another.

right coalition in power at the onset of the crisis with PDL's role as a member of the post-crisis grand coalition. In addition, the case study considers PDL's relationship with the technocratic government, which intervened between PDL's time in power. The chapter closes with a discussion of the relationship between the case studies and Chapter 3's large-N findings for the hybrid model proposed in Chapter 1. The closing section discusses endogeneity concerns over the relationship between external-actor pressure, consonance, and their respective effects of fiscal-policy outcomes.







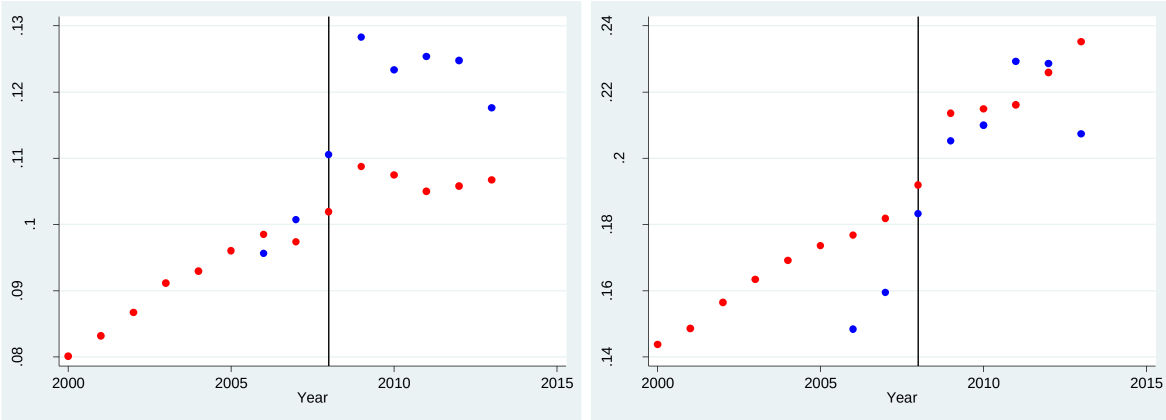


Figure 1. Disaggregated fiscal policies in Greece (in blue) and Italy (in red) between 2000 and 2013. A vertical line at 2008 indicates the onset of the financial crisis. The top three graphs show (from left-to-right and top-to-bottom) the tax rates on income, consumption, and corporate profits, respectively. The bottom two graphs (from left-to-right) show spending on public-sector compensation and social benefits, respectively.

Greece

In September 2007, New Democracy won a two-seat majority in Greece's parliament. In October 2009, following the onset of the financial crisis, George Papandreou's PASOK unseated New Democracy (ND). PASOK remained in power until, under pressure from both constituencies within PASOK as well as external actors, Papandreou ceded power to a technocratic administration in November 2011. In the May 2012 general elections, after ND's failure to form a grand coalition and Syriza's rejection of PASOK's offer to form a left-coalition government, June 2012 polls produced a grand coalition of ND, PASOK, and the Democratic Left. This coalition remained in power until January 2015, when Syriza and Alexis Tsipras rode to power on an anti-establishment, anti-austerity platform. At the time of writing the CMP had not analyzed the manifestoes from post-crisis Greek elections. As a result, in analyzing Greece, the case study considers only the policy outputs in Figure 1 and the accounts in the press (both domestic and international).

Greece under PASOK

In October 2009, George Papandreou's PASOK party defeated the incumbent conservative party, New Democracy. Papandreou campaigned on an anti-austerity platform and promised stimulus spending of €2.5 billion, in contrast to the austerity advocated by New Democracy.[2] With bond yields increasing in the wake of the PASOK's election victory and the government's 2009 deficit estimated at 12.7% of GDP—driven by the large increase in expenditure between 2008 and 2009, shown in the bottom two panels of Figure 1—Papandreou committed to a 3% budget deficit by 2013. The plan included a commitment to reduce the 2010 to 8.7% of GDP. At the time, it was unclear how PASOK would achieve such a target.[3] PASOK's commitment to a stringent deficit target reflected a wider pattern of commitments to fiscal targets in the Eurozone's peripheral countries, in which governments set ambitious targets accompanied by little or no detail on a realistic path.

To reduce the fiscal deficit, the government announced a number of measures in December 2009. These measures included a freeze on monthly public-sector wages in excess of €2000 and a 10% cut in public-sector allowances.[4] In February 2010, the government announced a monthly limit of €5000 in salary for executives at state-controlled companies in addition to increased consumption-tax rates on gasoline.[5] While Troika officials expressed support for the adopted measures, they encouraged further cuts to public-sector compensation and further increases in consumption taxes.[6] As in other crisis countries, the rating agencies exacerbated bond-yield pressure by downgrading Greek debt as a result of concerns over Greece's fiscal sustainability.[7] In March 2010, the Greek parliament passed additional measures, which included

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[2] "Papandreou's task; Greece's new leader must get down to business quickly." *Financial Times*. 6 October 2009.
[3] Akins, Ralph. "'Constructive ambiguity' has taken effect." *Financial Times*. 16 December 2009.
[4] Hope, Kerin. "Big turnout forecast for austerity package protest." *Financial Times*. 17 December 2009.
[5] Williamson, Hugh and Kerin Hope. "Greece unveils cuts to chief executives' pay." *Financial Times*. 10 February 2010.
[6] Hope, Kerin, Hall, Ben and James Wilson. "Greece to resist push for greater austerity." *Financial Times*. 15 February 2010.
[7] Kontgoiannis, Dimitris and David Oakley. "Tempers flare as credit warning sets back Greeks' efforts." *Financial Times*. 25 February 2010.

further increases in consumption taxes, cuts to public-sector wages, and a pension freeze.[8] The top-left and bottom-left panels from Figure 1 show the large increase in consumption-tax rate and reduction in public-sector compensation between 2009 and 2010.

Figure 2 in Chapter 4, and the subsequent analysis, showed that these measures temporarily halted increasing bond spreads in late 2009. By early 2010, bond spreads had resumed their upward trajectory, as financial-market participants began to question the credibility of Greece's proposed fiscal path. In April 2010, with the Greek government negotiating the first Greek bailout—for €110 billion—PASOK announced additional measures, worth roughly €30 billion, that focused on cutting public-sector compensation. The PASOK government instituted a three-year public-sector wage freeze and cut end-of-year bonuses for public-sector employees.[9] In addition, on the tax side, Athens levied a one-time corporate tax on 2009 profits and increased valued-added taxes by 10 percentage points.[10]

Following the bailout's announcement, bond yields fell and financial-market pressure temporarily receded. In this space, PASOK policymakers announced no additional reforms. Had the external environment remained calm, it is an open question whether the Greek situation would have deteriorated further. Hitherto, as documented in Chapter 4, financial markets had not yet priced in country-specific, sovereign credit risk as they would later in the crisis period. As a result, turbulence in Ireland, which received a Troika-financed bailout in November 2010, sent Greek yields upwards once again, forcing the hand of policymakers in Athens. In crafting the 2011 budget, the Greek government implemented another round of austerity measures. Emergency measures passed in December 2010 cut public-sector compensation and produced

[8] Hope, Kerin. "Measures set to undermine consensus on modernization." *Financial Times*. 6 March 2010.
[9] Hope, Kerin. "Greece agrees to €24bn of cutbacks." *Financial Times*. 30 April 2010.
[10] Hope, Kerin. "Athens accedes to austerity plan." *Financial Times*. 3 May 2010.

splits in PASOK, with four Socialist MP's voting against the measures; notwithstanding the MP rebellion, the measures passed parliament by a wide margin with 156 for and 130 against.[11] Later, in debates over the 2011 budget, despite urging of party unity, ten Socialist legislators threatened to bring down the government by voting against the budget.[12] Despite their threats, the budget passed parliament. The threatened dissidence, however, foreshadowed the debilitating internal tension within PASOK that would ultimately bring down the party and usher in a technocratic government headed by Lucas Papademos in November 2011. In May 2011, cabinet members divided publically on the pace of reform, with Andreas Loverdos, the Health Minister, explicitly criticizing the slow pace of reform.[13] By late May 2011, with bond yields above sustainable levels, it was clear that Greece would need either a bailout, debt-reduction, or both, in order to avoid bankruptcy. Policymakers in Athens advocated extending the maturity of the 2010 bailout, on top of the interest-rate reductions achieved in the March 2011 Grand Bargain.[14] One of many grand bargains brokered in the post-crisis period, as discussed in Chapter 5, the March 2011 Grand Bargain expanded the lending power of the EFSF in exchange for commitments from debtor countries to execute additional reforms.

Increasing political pressure within creditor countries guaranteed that additional relief would only occur in exchange for extensive and deep conditionality. Within the Troika and creditor governments, the primary debate revolved around the extent of private-sector involvement in the second bailout. The German government advocated extensive private-sector involvement, while the ECB, in particular, sought to shield private bondholders, out of concern

[11] Hope, Kerin. "Athens makes legislative dash to meet bail-out terms." *Financial Times*. 15 December 2010.
[12] Hope, Kerin. "Greece's PM calls for unity in budget debate." *Financial Times*. 20 December 2010.
[13] Hope, Kerin. "Greek cabinet falls out over reforms." *Financial Times*. 11 May 2011.
[14] Kontgoiannis, Dimitris. "Greece makes plans for bold tax move to cut budget deficit." *Financial Times*. 3 May 2011.

over the financial-market implications of "voluntary" negotiations.[15] Prior position, emphasized by the hybrid model as a relevant supply-side dynamic for external actors, explained Germany's position. German banks held small positions in Greece's private debt. This was not the case, however, with sovereign debt, whose restructuring was not considered because of the large positions of the Eurozone institutions and governments. In these negotiations, as elsewhere, France occupied a middle ground between creditors and crisis-country governments. The French government introduced a proposal for a debt-reducing bond-swap, modeled on Brady bonds. Chapter 5 discussed this scheme and the problematic analogy between Eurozone economies and 1980's Latin American economies operating with independent currencies. In June 2011, the ECB's view largely prevailed and limited the private-sector involvement in the second Greek bailout.[16] On the Greek side, Papandreou faced pressure from both within his own party and the opposition. About 30 PASOK legislators threatened to derail the required austerity legislation by voting against party lines. In addition, Antonis Samaras, the opposition New Democracy's leader, called for a renegotiation of the first Troika bailout.[17] How such a renegotiation would proceed remained unclear, but the broad-based rejection of past terms threatened to destabilize an already tenuous financial and political situation. Despite the threats, the government's four-year austerity package passed parliament, with extensive cuts to public-sector employment, a freeze in pension payments, increased consumption taxation, and extensive privatization of state-owned assets.[18] Amid continued public dissent within PASOK, particularly among the far left,

[15] Spiegel, Peter, Atkins, Ralph and Kerin Hope. "Lenders close to fresh deal for Greece." *Financial Times*. 6 June 2011.
[16] Peel, Quentin, Hope, Kerin and Robin Wigglesworth. "Berlin concedes on Greece rescue." *Financial Times*. 18 June 2011.
[17] Hope, Kerin. "Rift widens over Greek reform plan." *Financial Times*. 7 June 2011.
[18] Hope, Kerin. "Athens approves four-year austerity package." *Financial Times*. 10 June 2011.

Papandreou appointed Evangelos Venizelos, as part of a wider cabinet reshuffle that elevated far-left PASOK members, as Finance Minister.[19]

The Greek experience under PASOK's single-party government reveals an important shortcoming of the measure of consonance proposed by Equation 1, as it related to the hybrid model's vision of political capacity. Consonance reflects differences between, rather than within, parties. In the Greek case, with single-party governments in the pre-crisis and immediate post-crisis periods, the most important fiscal-policy tensions occurred within parties. Papandreou faced a difficult task in managing these tensions, particularly between the preferences of the far-left members of PASOK, the more pragmatic, office-seeking center of PASOK, and the hard line taken by Greece's creditors. Importantly, the importance of within-party tensions varied across the sample, even within the sample of single-party governments. Mass defections of the kind of observed in Greece were observed in neither Portugal nor Spain. On a smaller scale, however, they were observed in post-crisis Ireland. The concluding section of this chapter and Chapter 8 return to the problems posed by consonance as the exclusive measure of political capacity adopted in the present study.

A technocratic shift: Greece under Papademos

Shortly after PASOK's cabinet reshuffle in June 2011, Greek politicians expected Troika approval of the second bailout. However, Troika discussion over bailout terms stalled as a result of further debates over the extent of private-sector involvement in debt reduction.[20] In September 2011, as European politicians sought to gain domestic parliamentary approval for the second Greek bailout, the Troika warned Greece over its expected fiscal deficit of 9% compared with a

[19] Hope, Kerin. "Greek PM gives rival key post to placate party." *Financial Times*. 18 June 2011.
[20] Spiegel, Peter. "'Impossible knot' holds up bail-out for Greece." *Financial Times*. 5 July 2011.

target of 7.6% of GDP.[21] With growth declining in an already-recessionary context, the Troika called for additional credible austerity measures, increasing the pressure on recently appointed Finance Minister Venizelos. Lagarde threatened to withhold the IMF's next tranche if the pace of Greek reform slowed further.[22] In response, the Greek parliament passed a property tax that would be added to citizens' electricity bills.[23] After passing additional structural reforms, Papandreou faced increasing resentment from members of his own party and the wider public. With increasingly strident and violent protests, Papandreou declared a popular referendum on the terms of the second Greek bailout.[24] Troika policymakers reacted angrily and argued that, with a popular referendum, Papandreou abdicated responsibility at a critical moment for Greece. As a result, for the first time, Sarkozy and Merkel openly questioned Greece's future in the Eurozone and explicitly referred to the possibility of a Greek exit.[25]

In November 2012, Papandreou acquiesced to extreme pressure from both the Troika and the domestic political opposition and announced his intention to step down as Prime Minister.[26] The possibility of a grand coalition entering government to implement the terms the second bailout evaporated when talks between ND and PASOK stalled. Instead, the parties agreed to instate Lucas Papademos as Prime Minister presiding over a technocratic government until the February 2012 general election.[27] In late 2011, the widespread financial-market contagion analyzed in Chapter 4 produced a political analog, as governments across the Eurozone's

[21] "Troika warns Athens lack of progress will put bail-out loans in jeopardy." *Financial Times*. 3 September 2011.
[22] Spiegel, Peter, Beattie, Alan and Joshua Chaffin. "Lagarde warns IMF will hold back loan if Athens fails to act." *Financial Times*. 16 September 2011.
[23] Kontogiannis, Dimitris, Steinglass, Matt and Peter Spiegel. "Greek bail-out hit by legislative delay." *Financial Times*. 28 September 2011.
[24] Hope, Kerin and Peter Spiegel. "Greece to hold referendum on second EU bail-out agreement." *Financial Times*. 1 November 2011.
[25] Carnegy, Hugh, Giles, Chris, and Peter Spiegel. "Merkel and Sarkozy break currency bloc taboo." *Financial Times*. 4 November 2011.
[26] Barber, Tony. "An idealistic Greek patriarch putting the euro in jeopardy." *Financial Times*. 5 November 2011.
[27] Hope, Kerin. "Greek talks stall on coalition." *Financial Times*. 9 November 2011.

periphery collapsed in the face of increasing bond yields. In Italy, Mario Monti took over as Prime Minister of a technocratic government in Italy. At the same time, Spain's conservative Popular Party entered government with a majority in Parliament. The strong position of Spain's Popular Party, however, contrasted strongly with the incoming governments of both Greece and Italy. Whereas in Italy, the autonomy of the technocratic government was threatened by an overbearing predecessor (Berlusconi), in Greece, the Troika restricted the government's autonomy and directed the policy agenda. As occurred prior to Portugal's bailout in May 2011, the Troika required that both mainstream parties agree on the implementation of detailed austerity measures, prior to the disbursement of additional funds.[28] While such leverage likely paved the way for the short-term implementation of Troika demands, it also threatened the legitimacy of an already-embattled government.

Without legitimacy, it proved difficult for the Papademos government to pass either wider or deeper reforms than its democratically elected predecessor. In office for three months, the technocratic government began in a weak domestic position that only deteriorated further. As additional cuts became nearly politically impossible to implement, the technocratic government shifted its efforts to reducing tax evasion and improving collection. Estimates of foregone revenues as a result of tax evasion amounted to €6 billion annually, which would provide a potential windfall for a government able to achieve meaningful reform.[29] While commendable, such measures typically were not seen as a credible way to reduce the fiscal deficit. If credible, it was not clear why they would not be among the first measures implemented. As a last resort, they appeared almost as an admission of defeat. Moreover, progress on other fiscal fronts remained slow. Through the end of 2011, the planned privatization of €50 billion in state-owned

[28] Spiegel, Peter. "EU presses Rome and Athens." *Financial Times*. 14 November 2011.
[29] Hope, Kerin. "Tax collectors accused of bribery." *Financial Times*. 15 December 2011.

assets had generated only €1.3 billion.[30] As with combating tax evasion, the Greek government, in step with other crisis governments, frequently heralded privatization as a means of closing the fiscal deficit. Notwithstanding their widespread popularity, at least as measured by proclamation, privatizations were a problematic means by which to close the deficit for three primary reasons. First, the value of assets were typically overstated, as they had not been marked-to-market, since prior to the financial crisis. Second, privatizations were a one-off measure that reduced the year's deficit but did little to affect the structural deficit. Third, selling these assets, as revealed by the slow trickle of sales in Greece, were politically difficult propositions, with significant, entrenched interests organized in opposition.

Against the backdrop of a deteriorating political context, the external environment remained unforgiving. Despite the Troika's approval of a second bailout for Greece, none of the €130 billion had been disbursed because of stalled discussions among creditors with respect to the restructuring of Greek debt. The debate revolved around the tension inherent in implementing a sufficiently large haircut on the outstanding €200 billion in Greek debt that would improve Greece's debt sustainability while ensuring the voluntary participation of all private bondholders.[31] The one bright spot from the external environment involved Draghi's implementation of LTRO's (with two rounds occurring in December 2011 and February 2012), which facilitated the ECB's purchase of peripheral sovereign bonds and depressed yields.[32] In February 2012, Papademos and the Troika agreed to additional austerity measures that centered on public-sector pay cuts in addition to the implementation of those measures already agreed upon in exchange for a second bailout. The Greek parliament passed the austerity package,

[30] Chaffin, Joshua and Kerin Hope. "Red tape and graft stall sales of Greece's Olympic venues." *Financial Times*. 31 December 2011.
[31] Spiegel, Peter and Kerin Hope. "Greek default grows as talks falter." *Financial Times*. 14 January 2012.
[32] Oakley, David. "Italian yields drop as ECB funds kick in." *Financial Times*. 27 January 2012.

which Papademos sold as the better of two bad options. In a sign of the increasingly widespread dissent and deterioration of political consensus, 43 legislators from ND and PASOK voted against the bailout and were thus expelled from their respective parties. In addition, six cabinet ministers resigned from their positions following the vote.[33] Following the approval by Greek parliament, private bondholders reached an agreement for a haircut worth slightly more than 50% of the €206 billion in debt. Participation exceeded 95% of private-sector bondholders; the high level of participation largely reflected the generous incentives granted to the private bondholders by the ECB.[34]

The Papademos provides an unenviable means of avoiding the implementation of austerity measures in the near term: appoint a government with no domestic credibility. Figure 1 displays the fiscal-policy implications of the debilitating political context, characterized by parties and governments without credibility. Even against the back drop of strong external-actor pressure, measures of disaggregated fiscal policies remained flat between 2011 and 2012, as shown in Figure 2012. For anti-austerity advocates, however, delayed austerity does not mean no austerity, as indicated by the package approved at the end of the technocratic government.

A botched election, surging Syriza, and grand coalition

The policymaking power of the Papademos government was further undercut as the two primary parties (PASOK and ND) competed to position themselves as marginally anti-austerity. Both parties announced strategies to circumvent parliamentary approval and Troika conditionality for austerity-relief measures.[35] With the credibility of both PASOK and New

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[33] Hope, Kerin and James Wilson. "Greece votes for austerity as Athens erupts in violence." *Financial Times*. 13 February 2012.
[34] Hope, Kerin, Milne, Richard and Sam Jones. "Athens pushes bondholders on losses." *Financial Times*. 10 March 2012.
[35] Hope, Kerin. "Greek PM warns on threat to reform." *Financial Times*. 31 March 2012.

Democracy waning, in a dynamic that prefigured similar shifts in other post-crisis Eurozone countries, voters increasingly turned to parties on the edge of political spectrum: from the far-right Golden Dawn to the far-left Syriza. As a result, in the run-up to the May general election, PASOK and New Democracy, combined, polled at less than 40% of Greece's voting population.[36] In May 2012, the electorate failed to provide PASOK and New Democracy with a sufficient majority to implement the second bailout.[37] With Syriza, the second-leading vote recipient, unwilling to enter a left coalition with PASOK that would approve the second Troika bailout, Greece prepared for a second general election in June. In the interim, bond yields continued to climb, as political uncertainty rendered Greece's fiscal trajectory and future in the Eurozone uncertain.

The June 2012 election produced a grand coalition of three parties: Democratic Left, PASOK, and New Democracy. With the parties negotiating to enter government, the EC and the ECB approved a €100 billion bailout of Spain's banks, with limited conditionality, in stark contrast to the past bailouts of Greece, Ireland, and Portugal. Seeking analogous flexibility from the Troika, New Democracy, the leading vote recipient in the June election, requested a two-year extension to reach the fiscal targets required by the bailout program.[38] Junior coalition partners PASOK and Democratic Left voiced concerns about the social implications of continued austerity and concomitant economic contraction.[39] As the uncertainty continued into August 2012, debate increasingly revolved around Hollande's France, which advocated a relaxation of terms, and Merkel's Germany, which sought to protect the interests of creditors.[40] Both leaders

[36] Hope, Kerin. "Election backlash prompts threat to stability of Greece." 10 April 2012.
[37] Kerin, Hope. "Greece's two biggest parties suffer backlash to austerity." *Financial Times*. 7 May 2012.
[38] Spiegel, Peter. "Eurozone divided on terms of Athens rescue." *Financial Times*. 22 June 2012.
[39] Hope, Kerin. "Greek leaders identify cuts for Troika." *Financial Times*. 19 July 2012.
[40] Peel, Quentin. "Merkel and Hollande to grapple with Greece." *Financial Times*. 20 August 2012.

appeared to be appealing to their respective domestic constituencies, the socialist base in France and the conservative base in Germany. In September, Jean-Marc Ayrault, France's Prime Minister, explicitly expressed support for the extensions requested by Athens.[41] The IMF provided additional support for such a position.[42] Debate within the IMF went a step further, beyond an extension of debt and on to the restructuring of official debt (from the IMF, the ECB, and creditor countries).[43] The March 2012 restructuring of Greek debt had involved only private-sector bondholders. The pressure for heterodox reform dissipated, as documented in Chapter 5, with Hollande's shift squarely into the Northern camp.

The 2013 budget[44] reflected the pressures of external actors, who remained relatively unified programmatically, despite the IMF's intellectual dissent. Such pressures produced strains in the governing coalition. In November 2012, the leader of the Democratic Left, Fotis Kouvelis, publically repudiated the governing coalition's proposed budget, in protest of the implications of the budget for workers' rights.[45] This put the government in an untenable situation. Such behavior would have been unthinkable in the strong parliamentary contexts of other continental regimes. Even in countries in similarly dire financial straits, coalition partners exercised restraint with respect to the government's primary-cleavage platforms, as occurred in Ireland with both the Green's departure from the FF-PD-Green coalition in January 2011 as well as Labour's discontent throughout its participation in the post-crisis coalition with Fine Gael. Following the

[41] Hope, Kerin. "Paris focuses on Athens' Achilles heel to ease austerity burden." *Financial Times* 24 September 2012.
[42] Jones, Claire and Peter Spiegel. "German finance minister criticizes Lagarde call to ease up on austerity." *Financial Times*. 12 October 2012.
[43] Spiegel, Peter. "Eurogroup divided on path for faltering rescue." *Financial Times*. 9 October 2012.
[44] The fiscal data series for Greece ends in 2012. Thus, the remaining political narrative draws solely on press coverage.
[45] Hope, Kerin. "Kouvelis breaks ranks over reforms; Fotis Kouvelis." *Financial Times*. 7 November 2012.

vote, Greek policy employed water cannons to dispel protestors,[46] and party leaders in the governing coalition expelled seven legislators who voted against the budget.[47]

Greece's experience with post-crisis governments illustrates two important points related to the hybrid model that are explored in greater depth at the end of this chapter. First, the present study's emphasis on the operationalization of political capacity as consonance between coalition partners elides within-party tensions crucial to a complete understanding of fiscal policymaking. Second, the at-times direct relationship between pressure applied by external actors and domestic tensions in Greece's political context illustrates the problematic endogeneity between external actors and domestic political developments. Pressure from financial markets and the dictates of external actors drove both the appointment of Papademos' technocratic administration as well as the May 2012 electoral stalemate. If these political developments influence fiscal policy, as the hybrid model asserts, external actors provide ultimate cause driving change in fiscal policy in contrast to the proximate role played by low-consonance governments.

Italy

The politics of Italy's crisis and post-crisis periods can be roughly divided into three parts. In the first, running from April 2008 to November 2011, Berlusconi's People of Liberty led a center-right coalition in parliament. In November 2011, Mario Monti's technocratic government took over and remained in power until April 2013. In April 2013, Italian voters elected a grand coalition, which included both right and left parties.

[46] Hope, Kerin. "Greece approves fresh austerity measures." *Financial Times*. 8 November 2012.
[47] Hope, Kerin. "Coalition shaken despite winning austerity vote." *Financial Times*. 9 November 2012.

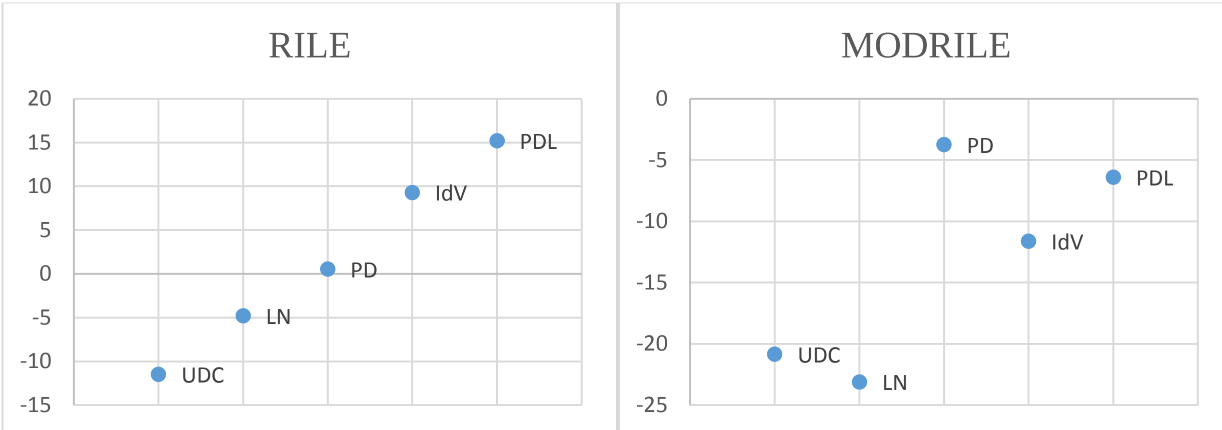

Figure 2. RILE and MODRILE scores from Italy's 2008 general election. In both graphs, parties are presented from left-to-right on the basis of their ranked RILE scores. In both panels, negative values indicate left positions, and positive values indicate right positions. Abbreviations are taken from the CMP codebook; the corresponding party names are listed in Table A1, in the appendix to this chapter.

Berlusconi's center-right coalition

Figure 2 reveals a number of important characteristics of Italy's 2008 general elections. First, the dramatic left-right variation in the RILE space was driven largely by non-economic factors, as the large differences in the RILE and MODRILE spaces indicate. In the RILE space, the center-left Democrats (PD) appeared to the right of the center-right People of Liberty (PDL). From an economic perspective, the PD and PDL were more closely aligned and to the right of the country's regional parties. Second, in contrast with Figure 3, which shows party positions in Italy's 2013 general election, the small number of parties in Figure 2 reveals the dominant tendency towards pre-electoral coalitions in Italy's political system. Many of the parties that later ran as independent parties in 2013 coalesced in the pre-electoral coalitions shown in Figure 2 in 2008. Such fracturing provided the Italian manifestation of the rejection of mainstream parties observed across the Eurozone's periphery.

In April 2008, Berlusconi's conservative coalition came to power on a campaign to restart Italy's economic growth by cutting taxes. The top three panels of Figure 1 show that Berlusconi had a specific variety of taxes in mind. Between 2007 and 2008, consumption and income taxes remained constant; corporate taxes, however, decreased by 7.5 percentage points.

With a larger economy than either Portugal or Greece, Italy, like Spain, entered 2010 in a strong bargaining position vis-à-vis the Troika. From the onset of the financial crisis, it was unclear whether the Troika would be able to bail out Spain, the Eurozone's fourth-largest economy. *A fortiori*, similar logic applied to Italy, the Eurozone's third-largest. As in the case of Spain, the interdependence of bond yields in the Eurozone, however, meant that Italian policymakers were not entirely isolated from the politics and economics of the Eurozone's smaller peripheral economies. As in Madrid, Berlusconi announced adjustment packages that coincided with the bailouts of Ireland and Portugal. In the weeks following the first Greek bailout in May 2010, with increasing pressure on Italian bond yields, Berlusconi reversed his expansionary campaign position. The Prime Minister announced cuts to public-sector compensation and increased taxation.[48] Figure 1 demonstrates a clear distributional basis for the tax-related adjustment. Income-tax rates increased between 2009 and 2010; corporate-tax rates, reduced in the previous year, remained constant. Moreover, the bottom-left panel shows the reduced expenditure on public-sector compensation.

As in post-crisis Spain, where autonomous regions disproportionately contributed to the rising deficit and debt, Italy's decentralized political structure meant that the burden of adjustment fell disproportionately on particular regions. Whereas in Spain, Catalonia resented fiscal transfers to less fiscally sound autonomous regions, economic conditions differed dramatically across Italy. In the North, strong manufacturing and financial bases drove growth; the South relied on a large public-sector and transfers from the north to maintain one of the Eurozone's highest standards of living. The Italian political landscape thus resembled Spain's, in the proliferation of regional parties. However, unlike in Spain, where the mainstream parties

[48] Dinnmore, Guy. "Berlusconi volte-face shocks Italy." *Financial Times*. 17 May 2010.

remained ideologically unified, Italy's system of loose pre-electoral coalitions generated strong tensions within parties akin to those observed in Greece's mainstream parties. This combination of regionalism and weak mainstream parties created an unstable electoral and political context, one particularly susceptible to financial shocks. In July 2010, following the announcement of Berlusconi's austerity package, the volatile combination produced strong dissent within the PDL, following a week in which two ministers resigned in the face of corruption allegations. To force the hands of the within-party dissenters, Berlusconi declared the austerity vote a vote of confidence, the thirty-fifth such occurrence during his two-and-half-year tenure as Prime Minister beginning in April 2008, warning that the government would fall if the package did not pass.[49] The frequent resort to the vote of confidence underscored the weak positions of Italian Prime Ministers, even those with parliamentary majorities.

Two days after the lower house approved the austerity package, Gianfranco Fini, co-founder of the PDL, departed from the governing coalition, along with 32 members of the lower house and ten members in the Senate. This dramatically reduced Berlusconi's parliamentary majority.[50] Since coming to power in 2008, Fini's business conservatism had co-existed uneasily with Berlusconi's pragmatic populism and political alliance with the xenophobic Northern League. Fini's departure dramatically reduced the odds of Berlusconi's government surviving an additional three years to the end of its term. This was particularly the case, given the loss of the governing coalition's majority in the lower house coupled with Berlusconi's penchant for pushing through controversial legislation with votes of no confidence. As a result of Fini's departure, negotiations over the 2011 budget included handouts to independents that reduced the

[49] Dinmore, Guy. "Berlusconi warns party dissenters over confidence vote on austerity." 9 July 2010.
[50] Dinmore, Guy. "Political divorce threatens Italy's coalition." *Financial Times*. 31 July 2010.

severity of planned reductions.[51] In December, Berlusconi barley survived a vote of no confidence in the lower house, by a count of 314-to-311, with two abstentions.[52]

Yields on Spanish and Italian debt continued to climb through middle of 2011, as the Troika's negotiations over the second Greek bailout stalled. By May 2011, Berlusconi had hinted that he would not stay in office beyond the current term. The Prime Minister indicated, at various times, support for Justice Minister Angelino Alfano and Finance Minister Giulio Tremonti as favored successor candidates.[53] Each prospective successor proved controversial for different reasons. Alfano, on the one hand, had worked to shield Berlusconi from prosecution in cases related to sex with a minor, tax fraud, and corruption. Tremonti, on the other hand, had implemented the first extended period of austerity in Italy since that which had accompanied Italy's accession to the Euro in the late 1990's. Berlusconi's support for each candidate vacillated, depending on popular perceptions and political conditions. At times, exacerbating the political, and thus financial, uncertainty, Berlusconi intermittently expressed an intention to continue as Prime Minister.

In June, Berlusconi clashed with Tremonti over how to finance a proposed growth plan, which included income-tax cuts, particularly among the wealthiest Italians.[54] Tremonti argued that, without compensating cuts in spending, the government could not afford the tax break. In response, Berlusconi announced a new round of cuts to expenditures. Adding €7.3 billion in cuts to the €25 billion already scheduled, the new plan included an additional €40 billion in adjustment over 2013 and 2014. The cuts concentrated on public-sector compensation, pensions,

[51] Dinmore, Guy. "Rome urged to take swift action over budget bill." *Financial Times*. 17 November 2010.
[52] Dinmore, Guy. "Berlusconi clings on after confidence vote win." *Financial Times*. 15 December 2010.
[53] Dinmore, Guy. "Tremonti at centre of leadership battle." *Financial Times*. 11 May 2011.
[54] Dinmore, Guy. "Italy PM labels speculators as 'locusts'." *Financial Times*. 22 June 2011.

and tax evasion.[55] With these measures implemented, the government projected that it would eliminate the fiscal deficit by 2014. In addition, the Prime Minister's involvement in the austerity package took on a more-than-political interest. Berlusconi, with the help of Justice Minister Alfano, attempted to shield the Prime Minister's media company Fininvest from paying court-ordered damages of €750 million. Only after public furor arose and President Giorgio Napolitano personally intervened did Berlusconi withdraw the shielding clause.[56] Notwithstanding such personal involvement, critics questioned the feasibility of the austerity program, which relied on secondary legislation to implement €23 billion in cuts.[57] Particularly in the context of a system with weak coalition governments dependent on small parties to pass legislation, the effect of controversial, fiscally conservative legislation is frequently watered down, as the government gathers sufficient legislative support. The requirements for such secondary legislation corresponded to calls in Greece to reduce tax evasion and to privatize state-owned assets. These praiseworthy, but ultimately unfeasible prescriptions, temporarily satisfied crisis-country creditors, until, for economic and political reasons, they proved impossible to implement. Whether crisis-country made such proposals in good faith or as a ploy in a context resembling Putnam's two-level game remains an open question and likely varies across cases.

With declining popularity in polls and a defendant in three separate trials—for alleged tax fraud, corruption, and sex with an underage prostitute—Berlusconi lashed out at his Finance Minister. A Berlusconi-owned newspaper quoted the Prime Minister describing Tremonti as a "socialist" intent on designing a "mamma state."[58] In doing so, Berlusconi undercut an emerging

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[55] Dinmore, Guy. "Italy to rule on €47bn savings drive." *Financial Times*. 30 June 2011.
[56] Dinmore, Guy. "Mystery clause fuels attacks on Berlusconi." *Financial Times*. 6 July 2011.
[57] Dinmore, Guy. "Italian austerity; Cuts must be accompanied by reforms to boost growth." *Financial Times*. 8 July 2011.
[58] Dinmore, Guy. "Berlusconi attack fuels Italy turmoil." *Financial Times*. 9 July 2011.

rival in the party and consolidated support among economically conservative coalition partners. In the weeks following the accusations against Tremonti, the government used a vote of confidence to force through the three-year, €45 billion austerity plan.[59] Pressures on Berlusconi to resign continued to intensify through the late summer. This pressure exacerbated internal tensions within the governing coalition, with party elites increasingly calling for the Prime Minister's resignation. These calls intensified as it became increasingly clear that the recently passed austerity package would not be sufficient to eliminate the budget deficit by 2014.[60] After the ECB announced that it would buy sovereign bonds in exchange for conditional reforms, Berlusconi announced an ambitious schedule of reforms. Without substantial accompanying detail, the embattled Prime Minister announced that the government would reduce the deficit to zero by 2013, rather than the 2014 target in the recently approved austerity package.[61] In the subsequent days, the government announced an emergency budget, which would add €45 billion to the €45 billion in adjustment approved by parliament in mid-July. The proposed budget would increase the income-tax rate on individuals earning more than €90,000, increase the tax rate on capital gains from 12.5 to 20%, and reduce the spending on local governments by €10 billion.[62] Berlusconi's government, however, could not survive while taxing its core constituencies. Umberto Bossi, leader of the Northern League, threatened to withdraw parliamentary support from Berlusconi's government if the emergency budget proceeded without amendment.[63]

Two weeks after announcing the emergency budget, in a nationally televised speech, the Prime Minister criticized the income-tax increases and cuts to spending on local governments.

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[59] Dinmore, Guy. "Italy passes budget but looks to Brussels for next move." *Financial Times*. 16 July 2011.
[60] Dinmore, Guy. "Markets force Berlusconi to break his silence." *Financial Times*. 3 August 2011.
[61] "Silvio's last chance; Italy needs Berlusconi finally to deliver economic reform." *Financial Times*. 10 August 2011.
[62] Segreti, Giulia. "Rome agrees austerity package to ease debt crisis." *Financial Times*. 13 August 2011.
[63] "Broken promises; Berlusconi waters down a much-needed austerity plan." *Financial Times*. 1 September 2011.

Berlusconi retracted key amendments, in a move of political capitulation that paralleled the referendum called by the PASOK government over the second Greek bailout.[64] Jean-Claude Trichet expressed reluctance to continue with purchases of Italian bonds as part of the Securities Market Programme after the Prime Minister's retraction. Trichet encouraged "absolutely decisive" reforms from Rome's governing coalition.[65] In response, the Prime Minister announced an increase in the VAT rates, a move that would become politically contentious under the subsequent administration.[66] Trichet's urgings betrayed an ignorance of Italy's political context; under duress, Berlusconi's coalition in particular and the Italian political system in general was incapable of decisive action which required reforms with strong distributional implications across broad swathes of voters.

Monti's technocratic government

By October 2011, the combination of internal voices calling for political change and external pressure created a political crisis that Berlusconi was forced to confront. That month, the governing coalition lost a parliamentary vote on the revised emergency budget.[67] In November, Berlusconi announced his intention to resign following the passage of additional austerity measures required by the European Union in exchange for continued bond purchases.[68] Later in the month, the Prime Minister reluctantly agreed to the formation of an interim technocratic government, which would be headed by Mario Monti with the parliamentary backing of the PDL and its allies. From the start, Monti's political independence was questionable, at best. Less than

[64] Sanderson, Rachel, Atkins, Ralph and Giulia Segreti. "Public outcry as Berlusconi goes back on budget." *Financial Times*. 31 August 2011.
[65] Atkins, Ralph. "ECB piles pressure on Athens and Rome in high-risk strategy." *Financial Times*. 5 September 2011.
[66] Dinmore, Guy. "Italy raises VAT to bolster austerity budget." *Financial Times*. 7 September 2011.
[67] Dinmore, Guy. "Berlusconi's future in balance." *Financial Times*. 12 October 2011.
[68] Dinmore, Guy, Segreti, Giulia and David Oakley. "Berlusconi's grip on power fades as he signals intention to resign." *Financial Times*. 9 November 2011.

a week into the life of the technocratic government, Berlusconi threatened to "pull the plug" on the nascent administration.[69] Berlusconi's support for the technocratic government remained crucial because of the People of Liberty's plurality in parliament, a plurality that would likely be required to pass any significant legislation. To underscore his ongoing importance, Berlusconi recommended that members of his party not support Monti, if the technocratic Prime Minister proposed a version of the wealth tax abandoned by the previous government.[70]

The composition of the technocratic government constituted a key difference between the technocratic governments in Greece and Italy. Whereas in Greece, politicians included in Papademos' 100-day administration were unelected, Monti's cabinet drew on elected politicians. This increased the democratic legitimacy of Italy's government but also reproduced some of the crippling political dynamics that initially brought the technocratic government to power. In initial negotiations between the largest right and left parties—Berlusconi's People of Liberty and Bersani's Democratic Party—senior politicians expressed reluctance to join Monti's cabinet, fearing that inclusion in the cabinet would hurt their prospects in the April 2013 general election.[71] The revised emergency budget reflected the political uncertainty facing the government. On the spending side, the package drew heavily on that designed by Berlusconi's government, reducing pensions as part of a larger envisioned shift from a defined-benefits to a defined-contributions system.[72] With respect to taxation, much to Berlusconi's and the Northern League's chagrin, the package relied on increased property taxation. Before passing Italy's lower

[69] Dinmore, Guy and Giulia Segreti. "Berlusconi 'ready to pull plug' on Monti." *Financial Times*. 14 November 2011.
[70] Dinmore, Guy and Giulia Segreti. "Monti rallies Italy to the cause." *Financial Times*. 18 November 2011.
[71] Dinmore, Guy and Giulia Segreti. "Political elite wary of joining Monti cabinet." *Financial Times*. 16 November 2011.
[72] In direct-contribution (DC) systems, benefits are directly related to contributions. In direct-benefits (DB) systems, benefits are unrelated to contributions. DB systems are thus more equitable but also more expensive. "Rome's long road to fiscal credibility; Mr. Monti's austerity package is a welcome first step." *Financial Times*. 6 December 2011.

house, however, the PDL managed to dilute reforms related to both property taxes and pensions.[73]

Some room for maneuver was opened by the easing of external conditions. Merkel praised the early reforms implemented by Monti, declaring them "extraordinarily important and remarkable" in both "speed and substance."[74] With Draghi taking over at the ECB, as documented in Chapter 5, the ECB cuts interest rates in consecutive meetings in addition to expanding the bank liquidity programs started under Draghi's predecessor, Jean-Claude Trichet. At the end of 2011, with bond yields on Italian debt responding positively to Monti's young administration, Monti called for a more robust European response, backed by a larger bailout fund[75] and a reduction in the interest-rate burden[76] of peripheral Eurozone countries. Monti's focus on debt sustainability mirrored the shift then occurring in the IMF. By February 2012, periphery bond yields had declined sharply and pundits around Europe celebrated the two Super Marios, referring to Mario Monti and Mario Draghi.

By April 2012, with Europe's attention increasingly turned towards the state of Spain's banks, Monti announced that his government would delay the goal of a balanced budget from 2013 to 2014. Monti also ruled out additional austerity measures in the intervening period.[77] Monti's statements reflected the anti-austerity shift in Eurozone opinion that accompanied Hollande's election to the French Presidency in May 2012. Despite these statements, Monti's government announced a €4 billion decrease in public spending. The government justified the cuts as being more growth-friendly than the planned VAT increases that had been originally

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[73] Dinmore, Guy and Giulia Segreti. "Risks persist as Monti's austerity plan wins backing." *Financial Times*. 17 December 2011.
[74] Peel, Quentin. "Italy's economic reforms win glowing approval from Merkel." *Financial Times*. 12 January 2012.
[75] Dinmore, Guy and Robin Wigglesworth. "Italy seeks bigger bail-out fund." *Financial Times*. 30 December 2011.
[76] Spiegel, Peter, Dinmore, Guy and Giulia Segreti. "Italian PM warns of austerity backlash." *Financial Times*. 17 January 2012.
[77] Dinmore, Guy and Giulia Segreti. "Monti delays goal of balanced budget." *Financial Times*. 19 April 2012.

scheduled.[78] While the economic justification for such a shift is debatable, the political logic is clear. The Northern League and other PDL allies in Parliament strongly supported lower taxes. Cutting spending was thus a way to satisfy Parliament's conservative constituencies while simultaneously meeting the deficit targets required to keep the European creditors satisfied.

The Northern League remained a key constituency for the technocratic government. With its boss and a number of senior members under investigation for corruption, the Northern League faced a loss of credibility akin to that faced by the mainstream parties replaced by the technocratic government. Filling in the electoral void, much like Syriza in Greece in 2012 and then again in 2015 and Ciudadanos and Podemos in Spain in 2014, an Italian anti-establishment party gained momentum. Headed by a comedian, Beppe Grillo, the Five Star Movement polled between the high single digits and mid-twenties in local contests throughout the first half of 2012.[79] In June, faced with declining popular support, Monti admitted that he "could have done more and better."[80] By mid-June leading into the summer's Eurozone Summit, yields on Italian and Spanish debt had started to creep upwards for two primary reasons. First, both Italian and Spanish banks came under scrutiny, as the value of assets obscured since the financial crisis received increasing attention from financial-market participants. A €100 billion bailout of Spain's banking sector sent tremors through Italian financial markets. Monti, however, insisted that Italy was not next in line.[81] Second, PASOK's fumbling of the second Greek bailout and the indecisive May 2012 general election in Greece fueled financial-market uncertainty. Italian yields remained elevated even after a grand coalition came to power in Greece. In Italy,

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[78] Dinmore, Guy and Giulia Segreti. "Monti draws up spending cuts to avoid tax rise." *Financial Times*. 1 May 2012.
[79] Dinmore, Guy and Giulia Segreti. "Monti counts cost as protest groups gain ground in Italy local polls." *Financial Times*. 10 May 2012.
[80] Dinmore, Guy. "Monti admits to losing support." *Financial Times*. 8 June 2012.
[81] Dinmore, Guy. "Italy denies it is next in line for bailout." *Financial Times* 13 June 2012.

observers began calling for early elections, rather than an extended period of political uncertainty that would last through the general elections scheduled for March 2013.

In May 2012, Renato Brunetta, the former minister responsible for public-sector reforms under Berlusconi, encouraged Monti to negotiate a separate growth compact with Eurozone officials at the summer summit dedicated to the fiscal compact.[82] Without such a compact, Brunetta implied that the Italian parliament would not ratify the fiscal compact.[83] At the Eurozone Summit, Monti, negotiating from a position of relative strength, rejected the offer of €120 billion in growth-enhancing measures. To go with such measures, Monti, with Rajoy's backing, insisted on debt relief. Eager to return with a result to placate his Socialist supporters at home, Hollande emerged as a cautious backer of the Italian and Spanish position.[84] Following the Summit, as discussed in Chapter 5, the establishment of the ESM and OMT initially appeared as significant and magnanimous concessions from the Northern to the Southern economies. As additional details emerged concerning the exclusion of legacy assets and the indirect mechanism of recapitalization, however, the policies appeared more akin to grudging concessions which would have limited financial-market impact.

Such conservative realities emerged gradually. With the initial announcement of Spain's bailout, the ESM appeared as a victory for the Southern economies. With its ostensibly new-found clout, and in light of lower-than-expected growth numbers, Monti's government reduced the income-tax rates in the draft 2013 budget.[85] In addition, the technocratic Finance Minister, Vittorio Grilli, argued that future cuts in expenditure should be coupled with reductions in

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[82] As noted in Chapter 5, the Eurozone summit produced the Treaty on Stability, Coordination, and Governance—the "fiscal compact"—in May 2012.

[83] Dinmore, Guy. "Monti urged to amend fiscal compact." *Financial Times*. 8 May 2012.

[84] Chaffin, Joshua, Spiegel, Peter and Hugh Carnegy. "Italy sours the atmosphere by refusing to sign off growth pact." *Financial Times*. 29 June 2012.

[85] Dinmore, Guy and Giulia Segreti. "Italy eases back on austerity with income tax cuts." *Financial Times*. 11 October 2012.

taxation to offset to the cuts' negative growth effects.[86] While some observers speculated that the brief respite in tax policy foreshadowed Monti's running in the March general election, the technocratic prime minister insisted that he would not run for an additional term. Support continued to migrate away from the traditional parties on the left and right and towards anti-establishment parties in general and Beppe Grillo's Five-Star Movement in particular.[87] With the election months away, the fractured center-left had not decided on a candidate, although focus had shifted to Matteo Renzi and Pier Bersani. Bersani ultimately won the PD's nomination in a December runoff with Renzi.[88] On the center-right, Berlusconi's camp announced, unsurprisingly, that Berlusconi planned to run again. At the time of his announcement, the former PM withdrew the PDL's parliamentary support for the technocratic government.

Monti recognized the impossibility of governing without the parliamentary support of the PDL. Monti thus agreed to elections after the passage of the 2013 budget.[89] Berlusconi announced an anti-austerity platform, similar in substance to the party's 2008 platform. The populist appeal reflected the political logic underscoring the departure of voters away from mainstream parties intent on implementing Troika policy. As a party led more by an individual than by an ideology, Berlusconi's People of Liberty was able to move around the policy space without losing voters. Other parties in Italy, with weaker and less wealthy personalities, struggled to maintain their core of supporters as they moved throughout the policy space. In contrast to Berlusconi's anti-Berlin platform, Bersani proposed a pro-European platform that

[86] Barber, Tony and Ferdinando Giugliano. "Grilli urges tax cuts instead of more austerity." *Financial Times*. 16 November 2012.
[87] Dinmore, Guy. "Monti faces pressure to continue as premier." *Financial Times*. 15 November 2012.
[88] Dinmore, Guy. "Bersani leads way to succeeding Monti." *Financial Times*. 4 December 2012.
[89] Dinmore, Guy and Giulia Segreti. "Former Italy PM offers to make U-turn." *Financial Times*. 13 December 2012.

relied on cooperation with Germany in exchange for the Troika's commitment to more growth-friendly measures.[90]

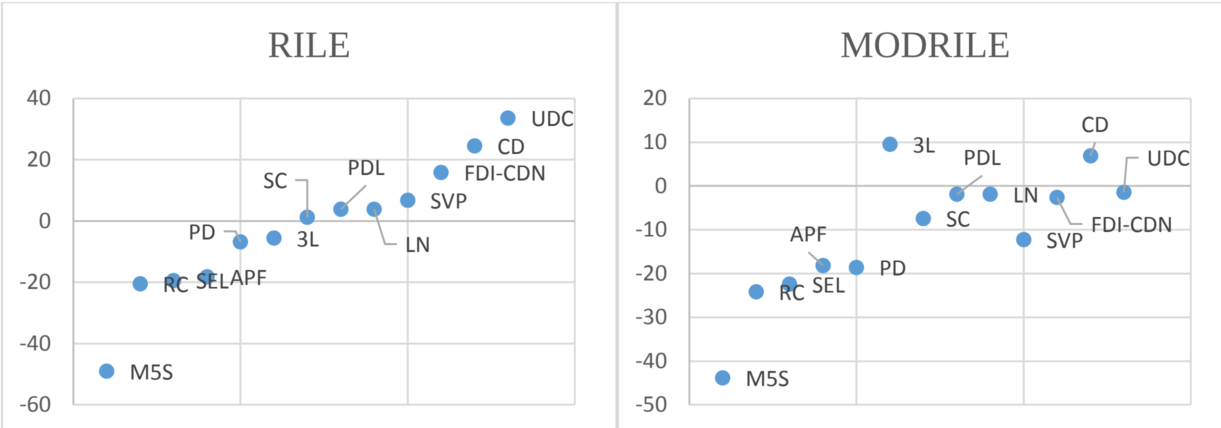

Figure 3. RILE and MODRILE scores from Italy's 2013 general election. In both graphs, parties are presented from left-to-right on the basis of their ranked RILE scores. In both panels, negative values indicate left positions, and positive values indicate right positions. Abbreviations are taken from the CMP codebook; the corresponding party names are listed in Table A1, in the appendix to this chapter.

An indecisive election and Enrico Letta's grand coalition

As Syriza's anti-European, anti-establishment position would take it to the top of Greek polls in 2015, Grillo's Five Star Movement gathered momentum, polling as the third largest party by late February.[91] With Grillo's strong showing, the possibility of a weak, center-left government with a majority in the lower house but a minority in the Senate became increasingly likely. Such a government would be unlikely to have the political capital required to implement controversial reform. The opening negotiations to form a coalition government confirmed these concerns and foreshadowed the limited room for policy maneuver that would be inherited by the subsequent government. Bersani's opening move of negotiating a minority government with Berlusconi's People of Liberty on the basis on a minimal five-point, anti-austerity framework received a weak response from Angelino Alfano, in his new role as the Secretary of the People of

[90] Fontanella-Khan, James. "Bersani calls on Europe to focus on growth; Italy." *Financial Times*. 27 December 2012.
[91] Dinmore, Guy. "Comedian's untested party fills critics with foreboding of tragedy." *Financial Times*. 23 February 2013.

Liberty.[92] With more than 160 seats between the two houses and collecting more than a quarter of the popular vote, Grillo's Five Star Movement occupied a key position within the electoral landscape. Following Syriza's lead after May 2012's election, Grillo repeatedly denounced the failures of the mainstream Italian parties and rebuffed the PD's offers to form a minority government.[93] In mid-April, after repeated failed attempts to form a coalition government, the leadership of the Democrats resigned. In their stead, Enrico Letta emerged as a viable leader of a coalition government to include his center-left Democrats, Monti's centrist Civic Choice, and Berlusconi's center-right People of Liberty. In his first speech as a leading candidate, Letta rejected the sustained policy path mandated by Brussels, saying that "Europe's policy of austerity is no longer sufficient."[94] A couple of days following the speech, Letta was sworn in. From the beginning of the administration, the tensions produced by a grand coalition were apparent. The People of Liberty insisted on the abolition of a housing tax repealed under Berlusconi that had been reinstated under Monti's administration. Berlusconi also wanted property-tax payments made under the Monti government to be reimbursed to property owners.[95] Bowing to pressure from the PDL, Letta announced that it would not collect the Monti administration's property tax and that it would not raise the value-added tax later in the year. Importantly, Letta's government did not announce offsetting measures.[96] In late May 2013, the EC gave its implicit approval of the Letta government's program, releasing it from the Excessive Deficit Program (EDP). At the same time, the EC allowed France and Spain an additional two

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[92] Dinmore, Guy, Barber, Tony and Giulia Segreti. "Bersani in opening gambit to break deadlock in Rome." *Financial Times*. 27 February 2013.
[93] Dinmore, Guy and Giulia Segreti. "Bersani takes 'responsibility' for trying to form government." *Financial Times*. 27 February 2013.
[94] Dinmore, Guy. "Choice for Italian PM urges end to austerity." *Financial Times*. 25 April 2013.
[95] Dinmore, Guy and Giulia Segreti. "Letta faces tough test in forming coalition." *Financial Times*. 25 April 2013.
[96] Dinmore, Guy and Giulia Segreti. "Letta tears up €6bn in tax rises." *Financial Times*. 30 April 2013.

years to reach the EDP-mandated targets.[97] In September, however, with increasing concern that Italy would exceed the 3% deficit target required under the EDP, Letta caved to EC pressure and announced a rise in the VAT.[98] This infuriated the PDL, one of whose conditions for coalition government, was the repeal of proposed VAT increases. After the rate hike went into effect, Berlusconi announced that PDL legislators would no longer participate in the coalition's cabinet.[99] The paralysis of the government persisted through the end of Letta's administration in February 2014, when Matteo Renzi took over leadership of the coalition government.

The policy paralysis of Letta's governments reflects the culmination and combination of tensions present throughout Italy's post-crisis governments. With prominent regional parties and strong ideological differences both within and between parties, the low-consonance environment sustained minimal controversial legislation. Even in the relatively high-consonance context of the center-right coalition led by Berlusconi's PDL early in the post-crisis period, the government was able to implement only limited fiscal-policy adjustment. Throughout the period, Italy produced structurally low levels of consonance that threatened the policymaking viability of any government. In such a setting, individuals dominated the political context, in a sense foreign to stronger-party parliamentary systems. Indeed, across crisis countries, no politician assumed the individual importance of Berlusconi, who, in a very tangible sense, was an Italian institution. This is problematic for a theories of policy, like the hybrid model and all of the dominant contemporary approaches discussed in Chapter 1, that are predicated on parties as the primary vehicle of policymaking. To the extent that an individual transcends the importance of his or her party, political competition tends to center more on personality than on the programmatic

97 "Europe loosens the fiscal belt a notch." *Financial Times*. 30 May 2013.
98 Dinmore, Guy and Peter Spiegel. "Letta's backing for VAT rises hits Italy coalition." *Financial Times*. 19 September 2013.
99 Mackintosh, James. "The short view." *Financial Times*. 1 October 2013.

cleavages emphasized in contemporary models. More broadly, this may pose a problem for the application of the hybrid model to weaker party systems and presidential systems without strong parties as institutions to structure debate and outcomes.

Greece, Italy, and the implications for the hybrid model

The juxtaposition of the Greek and Italian cases reveals the importance of a model that incorporates an understanding of domestic politics beyond partisanship. In the coalition politics that characterized post-crisis policymaking in Eurozone governments, tension between coalition partners played an important role in shaping the type and depth of fiscal-policy reforms implemented. As in Chapter 6, external actors played in important role in conditioning the autonomy of domestic actors. Financial markets imposed more serious restrictions on policymakers in Athens than in Rome. In the immediate post-crisis period, PASOK's single-party majority government, constrained by financial markets, implemented through extensive fiscal-policy adjustment. However, the political consensus underlying PASOK's dominance gradually deteriorated. This trend corresponded to one observed across all crisis countries, with the exception of Portugal, of electoral support shifting from mainstream parties towards fringe parties which touted anti-establishment and anti-European responses to the volatile status quo. The deteriorating political consensus undermined the efforts of the short-lived technocratic government headed by Lucas Papademos and then the grand coalition between PASOK, New Democracy, and the Democratic Left. Ultimately, unsatisfied with its voice in the grand coalition and the government's failure to produce viable alternatives to austerity, the Democratic Left withdrew from government. Greece's restricted autonomy contrasted with the relative freedom afforded to Italian governments by financial markets. To some extent, the added autonomy allowed Italian governments to implement its preferred version of austerity. This was particularly this case in the immediate post-crisis period with Berlusconi's center-right coalition. However, Italy's political landscape, riven by regional parties and dominated by a single individual, limited the ability of governments to implement the controversial reforms. As in Greece, this dynamic was exacerbated by the shift of voters from mainstream parties to the electoral fringe, dominated by Beppe Grillo's Five Star Movement. The subsequent grand coalition between the PDL and the Democratic Party suffered from a similar and debilitating lack of legitimacy as was faced by Greece's grand coalition.

Alternative operationalizations of political capacity

The case studies of post-crisis Greek and Italian governments highlight two obstacles to evaluating the role of political capacity in general and consonance, the operationalization of capacity adopted here, in particular. The first, borne out in the case studies, emerged in Chapter 3's large-N analyses and related to the specific operationalization of consonance as a measure of political capacity. Table 3 in Chapter 5 suggests that, within the high-consonance context, partisanship has little effect on fiscal-policy outcomes. This counters the prediction of the hybrid model, which suggests that the limited need to appease coalition partners should increase the differences observed between different types of governments in high-consonance settings relative to low-consonance settings. Instead, Table 3 suggests that differences between parties are more salient in low-consonance contexts than in high-consonance contexts. There are a number of potential explanations for this finding, each with serious implications for theories of fiscal-policy change. The first alternative explanation, discussed in the next section, involves the endogeneity between financial markets and fiscal policy. The second alternative relates to the specific operationalizations of political capacity adopted here. Chapter 1's initial presentation discussed political capacity in general, not consonance in particular. Consonance relates the tensions between parties in coalition government. The case studies suggest a number of other potential operationalizations, two of which are discussed here. First, as referenced in Chapter 3's discussion of the large-N analysis, tensions within, rather than between parties, may drive fiscal-policy outcomes. The cases studies of single-party governments most clearly illustrate this dynamic. In the immediate post-crisis period, PASOK's single-party majority government and Berlusconi's center-right coalition suffered primarily as a result of tensions within the dominant governing parties. In the Greek case, the departure of deputies produced the technocratic government headed by Papademos. In the Italian case, the departure of Fini and his allied deputies from the People of Liberty ushered in Monti's technocratic government. In each case, the disintegration of mainstream parties produced governments with limited domestic legitimacy. Notwithstanding marginal increases in legitimacy with respect to external actors, these governments faced nearly insurmountable political obstacles to implement a sustained regime of reforms. Second, an alternative operationalization could emphasize the distinction between strong- and weak-party systems, as in the framework of Carey & Shugart (1995).[100] Problematically, from the perspective of explaining variation in fiscal policies adopted following the financial crisis, the relative strength of party systems, as envisioned by the present literature, does not change over the life of the crisis. Such rigidity, however, does not reflect the realities of Greece and Italy, in which the structure of political institutions are largely endogenous to the preferences of incumbent governments.

In principle, these alternative versions of political capacity are not mutually exclusive. Indeed, the myriad varieties of political capacity suggests a final point regarding potential heterogeneity in the effects of different dimensions of political capacity across the sample.

[100] Carey, John, and Matthew Shugart. "Incentives to cultivate a personal vote: a rank ordering of electoral formulas." *Electoral studies* 14.4 (1995): 417-439.

Different dimensions of political capacity—consonance, within-party tensions, and strength of party systems—may have different effects both within and between crisis countries. Thus, an important avenue for future research involves evaluating the relative explanatory power of these different dimensions of political capacity. All could be included in a single model; however, as discussed in Chapter 1's introduction of the hybrid model, an important tension in modelling revolves around the tension between parsimony and generalizability.

Fiscal policy, financial markets, and endogeneity

The second obstacle to evaluating the role of consonance in the hybrid model relates to the endogeneity between financial-market pressure and political conditions in general and consonance in particular. The hybrid model proposes a direct link between consonance and fiscal-policy outcomes, with causality running from the former to the latter. The case studies however reveal a complicated relationship between financial markets, consonance, and fiscal-policy outcomes. In the cases of Greece and Italy, in particular, the financial markets and external actors restrict the set of feasible domestic coalitions. In the former, external actors lobbied heavily for a grand coalition of mainstream parties in May 2012's general election. Syriza's platform that demanded a renegotiation of the terms of the two prior bailouts rendered it unacceptable to the Troika. The low-consonance grand coalition that emerged following the June 2012 election thus resulted, in part, from the pressures applied by external actors. In Italy, the Five Star Movement's unwillingness to negotiate with the Troika produced a grand coalition between mainstream parties that ignored the preferences of a significant and growing proportion of the Italian electorate. The policy malaise that emerged from grand coalitions with limited and deteriorating domestic legitimacy stemmed in only a proximate sense for the low-consonance conditions. Ultimately, external actors drove the observed fiscal-policy outcomes.

The case studies thus reveal important heterogeneity related to the effects of external actors. Their direct effect through a variety of measures, with varying degrees of conditionality, is to increase the extent of adjustment in crisis countries. Moreover, to the degree that supply- and demand-side factors favor the Troika, fiscal-policy adjustment in crisis countries mirrors the preferences of the Troika's dominant actors. The indirect effect of pressure from external actors is mediated by consonance and limits the extent of fiscal-policy adjustment in crisis countries. Financial-market pressure circumscribes the set of viable parties in power and thus governing coalitions. This tends to both reduce the consonance of incoming governing (through, *inter alia*, encouraging the formation of grand coalitions) and undermine the domestic legitimacy of the subsequent government. These twin dynamics severely limit the subsequent government's ability to implement controversial reforms. In revealing the nuanced role of external actors in influencing policymaking in crisis countries, the case studies emphasize the limited, independent role played by consonance in shaping fiscal-policy outcomes. Importantly, the same conclusion does not necessarily apply to political capacity more broadly; alternative operationalizations of political capacity may independently influence policymaking in crisis countries to a greater extent than consonance.

Appendix to Chapter 7

Abbreviation	Party name (in English)
M5S	Five Star Movement
RC	Civil Revolution
SEL	Left Ecology Freedom
APF	Autonomy Progress Federalism Aosta Valley
PD	Democratic Party
3L	Labour and Freedom List
SC	Civic Choice
PdL	People of Freedom
LN	Northern League
SVP	South Tyrolean People's Party
FDI-CDN	Brothers of Italy-National Centre-Right
CD	Democratic Centre
UDC	Union of the Center (prior to 2008, Union for Christian and Center Democrats)
IdV	Italy of Values

Table A1. Party abbreviations and full party names from Italy's 2008 and 2013 elections translated into English, according to the CMP. Parties are listed according to their ranked RILE scores in 2013, starting with the leftmost party at the top. IdV, listed below the black cells, participated in the 2013 but not as an individual party in the 2008 general elections. In the 2008 election, IdV participated as part of a coalition with Civil Revolution (RC).

Chapter 8: Conclusion

Introduction

Chapter 8 is divided into four sections. The first section discusses the alternative approaches to explaining fiscal-policy outcomes introduced in Chapter 1. In particular, the section discusses the shortcomings of these models and how the hybrid model contrasts with such approaches. The second section discusses the core results that emerge from the quantitative and qualitative analyses in Chapters 2 through 7. Subsections address each component of the hybrid model. The third section summarizes a number of empirical and theoretical challenges confronting both the present application of the hybrid model in particular and studies of fiscal policy in general. The fourth and final section discusses applications beyond the Eurozone presented in the present study.

Alternative approaches

Chapter 1 introduced three alternative approaches in the political science literature that purport to explain variation in fiscal policies adopted following financial crises. The first, partisan Meltzer-Richard models, emphasizes the domestic context and competition between parties on the left and on the right. While an important step in evaluating the role of domestic politics in fiscal policymaking, these models fail to provide a convincing explanation for center-right policies adopted by center-left parties, and vice-versa. The second and third approaches, in the convergence and varieties of capitalism (VoC) literatures, emphasize the fiscal-policy consequences of pressure applied by financial markets. These two literatures take as their point of departure the notion of footloose capital developed by Rodrik.[1] In an international environment characterized by capital mobility, parties on the left and right converge on a

[1] Rodrik, Dani. "Sense and nonsense in the globalization debate." *Foreign Policy* (1997): 19-37.

trivially low corporate-tax rate in order to prevent capital from departing for low-tax localities. In the convergence literature, these pressures generate a single equilibrium, in which all countries converge on a similar, low-tax equilibrium. In the VoC literature, these pressures generate two equilibria, differentiated on the basis of the relationship between state and market in each. In liberal-market economies (LME's), market forces dominate and coordinate the behavior of economic actors. In coordinated-market economies (CME's), the state plays a larger role in coordinating such behavior. As a result, in LME's the state is minimal and characterized by a laissez-faire approach; in CME's, the state is more expansive and characterized by institutions that foster cooperation and resolve conflict between groups in the economy, such as employers and employees.

Shortcomings of the alternative approaches

Each of the dominant approaches faces important challenges in explaining fiscal-policy responses to the 2008 financial crisis. The partisan MR approach fails to provide an explanation for a number of political strategies and policy outcomes observed following the crisis. In Ireland, parties across the political spectrum, with the sometimes exception of Sinn Fein, supported Ireland's Eurozone-low 12.5% corporate-tax-rate. More broadly, center-right parties implemented ostensibly center-left policies, and center-left parties implemented policies traditionally associated with the center-right. That said, despite the empirical shortcomings, important elements of the MR approach, including the basic tension between left and right, are preserved in the hybrid model. To varying degrees, particularly in the absence of pressure from external actors, partisan conflict proceeds as conventionally conceived in the MR approach.

The convergence literature faces different but similarly significant problems. The most basic fiscal-policy consequence of the convergence model—convergence of the corporate-tax rate—is not observed across the Eurozone. Neither does the corporate-tax-rate trend down universally. Instead, it is the object of political contention, increasing in some countries and decreasing in others. As with respect to MR, despite the empirical shortcomings of the convergence literature, the approach produces important insights into fiscal policymaking, particularly during periods of economic dislocation and financial stress. In particular, the hybrid model internalizes the financial-market pressures emphasized in the convergence approach. In contrast to past approaches, however, such convergent pressures vary over space and time. Importantly, the hybrid model explicitly theorizes the dynamics underlying such variation.

The VoC approach predicts two equilibria, within which there should be trivial variation. While the Eurozone's countries vary in extent to which they conform to Hall & Soskice's vision of CME's,[2] their relative similarity within the VoC typology should induce similar fiscal-policy regimes. While a reasonable interpretation of the typology would permit variation, the wholesale differences between and within crisis countries under different governments implies a broad-based under-specification of the VoC framework. As with the MR and convergence approaches, the hybrid model draws important lessons from the VoC literature. In particular, the present model incorporates the VoC's coalitional logic for why parties diverge and how governments resist financial-market pressure.

Comparison with the present model

The present model, and empirical operationalization, builds on the dominant approaches in three important ways. First, on the empirical side, the model disaggregates the dependent variable of fiscal policy. Contemporary approaches to the academic study of austerity, including empirical applications of all three dominant approaches, employ highly aggregated measures of

[2] Hall, Peter A., and David Soskice, eds. *Varieties of capitalism: The institutional foundations of comparative advantage*. Oxford University Press, 2001.

austerity. At their most aggregated, these studies analyze the fiscal deficit as a proportion of GDP. This approach ignores the important distributional consequences of revenue-driven versus expenditure-driven adjustment. A second set of studies, more disaggregated than the first, considers government adjustment as a function of expenditure and revenue. Even these more refined approaches, however, elide the political conflict surrounding specific tax-and-spend measures. Chapter 1 develops a theory to account for the distributional implications of specific, disaggregated tax-and-spend measures. In addition, Chapter 2 presents the refined data required to test the more nuanced model. In contrast to past studies that consider deficit, expenditure, and revenue as proportions of GDP, Chapter 2 presents four tax measures (consumption, corporate, income, and social security) and two expenditure items (public-sector compensation and social benefits), with distinct distributional, and therefore political, implications in the context of the Eurozone's complicated coalition politics. Chapters 3, 6 & 7 show that Eurozone governments, in both crisis and non-crisis countries, respond with these disaggregated measures, rather than at the level of the deficit. Importantly, however, the model restricts that the variation at the levels of both the independent and dependent variables. As noted in Chapter 1, a more realistic model would develop a more sophisticated domestic politics, both within and between parties; a more complicated model might also incorporate a richer institutional context, which would include employer organizations and unions, a la Hausermann. Moreover, a deeper approach would consider a wider and further disaggregated set of tax-and-spend policies. As a first approximation, building on the incomplete models offered by contemporary approaches, Chapter 1's model offers an important but incomplete step towards understanding how countries employ fiscal policy to respond to financial crises.

Second, on both empirical and theoretical sides, it builds on the rudimentary domestic political contexts offered in the MR and VoC approaches. On the empirical side, Chapter 2 presents a more nuanced measure of preferences over fiscal policy than is adopted in the wider literature. In the MR approach, domestic political competition consists of parties on the left and right competing against one another. According to this vision, parties exhibit preferences with respect to expenditure and revenue; the left favors high levels of both, and the right favors low levels of both. The CMP's RILE measure, the dominant measure of right-left partisanship employed by the literature, includes a large number of non-economic measures, as shown in Table 1 of Chapter 2. MODRILE, the original measure of economic-policy preference adopted here, also shown in Table 1, extracts the economic-policy dimension from RILE. Chapters 6 & 7 show that important divergence between MODRILE and RILE measures across crisis countries. Following periods of financial crises, when economic policy is particularly salient, MODRILE more accurately captures the relevant variation in political preferences. The hybrid model advances present approaches and accurately captures the coalition dynamics common in Eurozone governments. On the theoretical side, Chapter 1's model incorporates a more sophisticated model of coalition government that accounts for tension between coalition partners, absent from the single-party governments envisioned by the MR approach. The measure of political capacity adopted here captures the tension between parties in coalition governments. As discussed in Chapters 3 & 7, expanding the present to model to incorporate tensions within political parties provides an important extension of the present study.

Third, on the theoretical side, the hybrid model integrates the domestic political logic of the partisan MR approach with the international economic logic of the convergence and VoC approaches. Past approaches separate the domestic and international contexts. The present model explores if and how external actors influence domestic policymaking. The approach, in contrast to the ubiquitous pressure posited by the convergence and VoC approaches, suggests that the influence varies over time and space as a function of both supply and demand factors. The hybrid model emphasizes the importance of financial markets as mediating between external actors and domestic politics. Chapter 4 explores how such mediation evolved between 2000 and 2013, as financial markets increasingly priced in country-specific, sovereign-credit risk. In the immediate, post-accession period, yields on peripheral bonds converged to the German bund and effectively eliminated credit risk. Such a permissive environment provided external actors with little influence in the policymaking of Eurozone member countries. With the emergence of sovereign-credit risk, first as a systemic phenomenon and later as a more differentiated country-specific phenomenon, external actors gained increasing leverage in the affairs of member-states. The three primary innovations of the present approach, which feature a combination of theoretical and empirical nuances, contribute to a richer model of fiscal policymaking following financial crises. The results, presented in Chapters 2 through 7, both highlight the importance of added elements and underscore the importance of further refinement, with respect to both theory and empirics.

Results and their theoretical implications

The time series of disaggregated fiscal policies, presented in Chapter 3, display a characteristic pattern across the Eurozone. Figure 1 of Chapter 3 shows that deficits increase, then decrease, following the financial crisis. Importantly, obscured by the aggregate deficit, crisis countries exhibited larger declines in both expenditure and revenue compared with non-crisis countries. Such results provide a first impression of the importance of external actors, whose influence varies as a function of financial-market pressure, and reveals how such patterns are not visible in the context of highly aggregated measures of fiscal policy. Moreover, the bottom two panels of Figure 1 show that the post-crisis increase in deficit stemmed from collapsed revenue, rather than the increased expenditure characteristic of Keynesian response. This contrasted with the predominantly Keynesian narrative produced by the financial press.

Further disaggregated, expenditures and revenues generate clear patterns that pose important challenges for the convergence approach. Figure 2 of Chapter 3 shows that, following the crisis, as predicted by the convergence approach, expenditure on public-sector compensation and social benefits declines. Problematically, however, for the convergence approach, both components of expenditure increase in the post-accession, pre-crisis period. Moreover, in the post-crisis period, both components of expenditure continued to increase among non-crisis countries. In the aggregate, both components of expenditure decline across the Eurozone; Figure 2 demonstrates, however, that the aggregate effect is driven by large declines in crisis countries contrasted with steady increases in non-crisis countries. Disaggregated components of revenue, displayed in Figures 3 through 6 of Chapter 3, generate similar problems for the convergence approach. Across the sample, in contrast to the homogeneous low tax-and-spend equilibrium predicted by the convergence approach, substantial heterogeneity emerges. By integrating the preferences of external actors, mediated by financial-market pressure, with the domestic politics of fiscal policy envisioned by a domestic MR approach, Chapter 1's hybrid model—and the subsequent chapters' empirical applications—provide better explanation for the time-series, cross-section variation.

Partisanship

Chapter 3 employs t-tests and fixed-effects regressions to explore the role of partisanship in shaping fiscal policymaking. Both sets of tests confirm and advance the findings of the time-series analysis. The t-tests provide the broadest test of the partisan hypotheses implied by the hybrid model and characterize effects on the basis of both between-country and within-country variation. Fixed-effects regressions identify effects on the basis of only within-country variation but control for a wider set of covariates than t-tests, including those implied by the hybrid model. The large-N inferential methods reveal consistent and significant effects with respect to the deficit, revenue, and expenditure. When disaggregated, due to limited within-country variation and the lack of associated power in fixed-effects regressions, coefficient estimates are rarely statistically significant, less frequently in than in the case of t-tests. Broadly, however, the substantive findings coincide with the predictions of the hybrid model.

Large-N inferential methods suffer from two related shortcomings. First, in an attempt to reduce unobserved heterogeneity, fixed-effects regressions limit the amount of exploitable variation. Second, because of such limited variation, regime effects are difficult to characterize. The findings with respect to corporate-tax rates provide an example of the inferential problems introduced by these shortcomings. Left governments tended to be in power in the pre-crisis period, which was characterized by financial-market conditions that allowed crisis countries to fund large fiscal deficits without raising taxes. Under this regime, governments reduced corporate-tax rates, as described in Chapter 3's analysis of Figure 2. Right governments entered power after the anti-incumbent elections in the post-crisis period. With tighter financial-market conditions, right governments employed fiscal measures to cover the growing fiscal deficit. In this environment, right governments held corporate-tax rates constant while increasing income- and consumption-tax rates. When viewed in the aggregate, the left governments appeared to treat corporate interests more favorably than right governments. Thus, ignoring the regime effects implied by financial-market conditions can produce spurious inferences.

These difficulties underscore the importance of qualitative approaches, which inform and refine the understanding of political context required to sensibly interpret large-N analyses. Chapter 6 develops qualitative case studies that juxtapose analyses of Spain and Portugal. These analyses provide detailed context that inform the application of the hybrid model. With Spain's relatively permissive, financial-market conditions, governments on the left and right operated with significant latitude. The autonomy of policymakers in Madrid contrasts with the straitened circumstances faced by Lisbon's, who, because of climbing yields were unable to fund the fiscal deficit on capital markets. Lisbon's politicians thus produced policy that corresponded more closely to the preferences of external actors than that produced by Madrid's.

Consonance

Chapter 3's large-N analysis reveals a more limited impact of consonance than is predicted by the hybrid model presented in Chapter 1. Consonance appears to have a limited effect on fiscal-policy outcomes. Table 5 of Chapter 3 shows that the effect of partisanship is not intensified in high-consonance contexts. Indeed, partisan differences are statistically significant only in the low-consonance context.

Chapter 7's case studies of Greece and Italy suggest a number of reasons for the limited significance of consonance, the first statistical and related to the presence of endogeneity in the proposed model, the second empirical and related to alternative operationalizations of political capacity. As with respect to partisanship, concerns about endogeneity between consonance and the remaining explanatory variables (partisanship and external actors) present inferential difficulties. As presented in Equation 1 of Chapters 2 & 7, the statistical relationship between consonance and partisanship is, in part, structural. A shift in consonance requires a corresponding shift in partisanship. Thus, evaluating the independent effect of consonance is impossible. Chapter 7 shows that, in contrast to the direct line of causality from consonance to fiscal-policy outcomes implied by the hybrid model, financial-market pressures tend to reduce the consonance of governments and coalitions that emerge from the electoral context. Thus, consonance appears to mediate the effects of financial markets on fiscal-policy outcomes, rather than directly influencing outcomes. While a problem for statistical identification, the dependence of consonance is not necessarily a death knell for the hybrid model. The hybrid model can accommodate mediating variables with limited direct influence on fiscal-policy outcomes.

It is important to the note that, in the initial presentation of the hybrid model, Figure 1 in Chapter 1 presented political capacity, not consonance, as an explanatory variable added to the partisan politics of an unreformed MR model. Chapter 2 thus presents consonance as one manifestation of political capacity. The weak results with respect to consonance do not nullify the effects of political capacity more broadly. Indeed, Chapter 7 suggests a variety of different dimensions of political capacity, including internal party tensions and party-system strength, which may drive the depth of fiscal-policy reforms. Ultimately, the particular drivers of political capacity may vary across crisis countries to an extent that any single operationalization will explain variation in a small, and statistically insignificant, subset of the broader sample. As a modeler, seeking to generalize beyond the individual case studies of journalists, such variation presents an important challenge, particularly if the model is going to apply without extraordinarily refined scope conditions.

External actors

Chapters 4 & 5 explore the role of external actors, the final explanatory model presented in the hybrid model, in shaping fiscal-policy outcomes in crisis countries. Chapter 4 employs factor analysis to analyze the correlation of sovereign yields over the sample period. The analysis reveals three distinct periods of bond-market behavior. In the pre-accession period, bond yields of prospective Eurozone members converged to the German bund. In the post-accession, pre-crisis period, spreads remained low, as financial markets failed to price in country-specific, sovereign-credit risk. In the final period, strong correlation among crisis countries persisted, with increases in Greek yields driving up yields across the sample of crisis countries. Only late in the period, after the second Greek bailout and associated restructuring of Greece's debt, did significant differences in bond yields emerge among crisis countries.

The gradual pricing-in of country-specific, sovereign debt risk reflected the increasingly refined tools employed by the Troika over the period, as explored in Chapter 5. Chapter 5 considers the set of policy interventions employed by the Troika, including conventional and unconventional monetary policies, bailouts, and EU-wide legislation. One broad way to interpret the evolution of Troika tools is from general measures that targeted the Eurozone as a whole towards tools capable of targeting specific crisis countries. Early in the crisis, the ECB relied on cuts to the nominal interest rate; such monetary policy applied across the Eurozone and thus had no differential effect either within or between crisis- and non-crisis countries. Moreover, bond purchases in the pre-crisis and immediate post-crisis period occurred through the Securities Markets Programme which required little conditionality. The Greek bailout began a trends towards increasing conditionality and the Troika's increasing involvement in the affairs of the individual Eurozone member countries. The Greek bailout, along with all subsequent bailouts with the exception of Spain's, required substantial fiscal adjustment, with ongoing, intrusive monitoring provided by Troika observers. Bond purchases, first coordinated through the SMP, later occurred as part of Outright Monetary Transactions and the European Stabilization Mechanism, which both required conditional reforms in exchange for bond purchases. Such evolution demonstrates the increasing and refined reach of Troika technocrats into the affairs of Eurozone member states. As a result of such refinements, financial markets increasingly priced in country-specific, sovereign-credit risk.

Notwithstanding the increasingly refined reach of the technocrats, the Troika confronted significant obstacles to collective action throughout the crisis period. The hybrid model proposes, and Chapter 5 explores, three such dynamics: emergent preference heterogeneity, prior position, and the arrival of additional external actors. Preference heterogeneity first emerged as the IMF's non-European member countries resented what they saw as preferential treatment granted to Europe's crisis countries compared to that granted to Latin American countries in the 1980's and East Asian countries in the 1990's. Exacerbating this split, particularly following the first three bailouts between May 2010 and May 2011, IMF technocrats expressed increasing concern over the debt sustainability of crisis countries. These officials clashed with ECB technocrats who viewed the crisis as one motivated by liquidity risk rather than solvency risk. Prior position, the second supply-side dynamic emphasized by the hybrid model, increased in importance as Eurozone governments amassed positions in the sovereign debt of crisis countries. The large positions explain the unwillingness of the Troika to impose restructuring on Greece's publically-held sovereign debt following the second Greek bailout. Moreover, because of its small positions vis-à-vis the remainder of the Eurozone, Cyprus, the country most affected by the restructuring of Greece's privately-held sovereign debt, was unable to alter the decisions shaped by the Eurozone's largest economies. The third and final supply-side dynamic emphasized by the hybrid model, the arrival of additional external actors, played a role later in the sample period. Cyprus, in order to avoid the extensive conditionality required by the Troika, sought funds from the Russian government. In December 2011, Moscow extended a €2.5 loan to Nicosia. In this manner, the Cypriot government was able to avoid the Troika-imposed reforms until April 2013, when it entered a Troika program. The relationship with Russia thus delayed, but did not eliminate, the imposition of Troika-mandated reforms in Cyprus.

Challenges for fiscal-policy research

Two primary challenges confront studies of fiscal-policy research in general and the Eurozone crisis in particular. With respect to the former, the strategic revelation of preferences by political actors makes it difficult to measure the true preferences of political actors. With respect to the latter, the complicated relationship of the Troika's various actors makes attribution of responsibility for policy evolution difficult. To an extent, the theoretical framework and empirical methodology in the preset dissertation have addressed these problems; however, even ameliorated, they continue to pose significant inferential difficulties.

As a large literature documents, measuring the preferences of any actor poses significant problems. This is particularly the case in a strategic setting, as in the present case, where actors have incentives to appeal to constituencies whose preferences are either unknown or known to diverge from the actors' true preferences. Several methods have arisen to deal with this challenge. First, researchers ignore the problem and treat the policy outcome as revealed preference. Second, researchers employ a number of sources of information that emerge prior to the observed policy outcome. These sources include politician and party statements, manifestos, and other miscellany. Third, survey experiments of politicians and constituents allow for an accurate identification of preferences among listed choices. Fourth, relatively nascent approaches in the literatures linking political psychology and neuroscience may provide a means to characterize and investigate political preferences. To date, these methods are neither scalable nor fully developed.

The present study adopts the second approach. In this vein, it follows Hausermann (2010). Whereas Hausermann employs a variety of documents, the present study analyzes manifestos written prior to the election. Unfortunately, particularly in the context of prospective coalition governments, manifestos reflect the strategic consideration of political parties vis-à-vis potential coalition partners. Notwithstanding such shortcomings, deriving preferences from manifestoes marks a significant improvement upon deriving preferences from policies adopted. An important venue for future research involves further study of the preferences of political parties. The third and fourth options listed above, survey experiment and mapping via neuroscientific methods, provide two opportunities. Gaining access to, and the willingness of, senior politicians to submit to such intrusive methods will likely be difficult, if not impossible. Rather than trying to measure the preferences of actors directly, a separate approach might focus on assessing the preferences of constituents. The preferences of constituents can then be taken as a proxy for the preferences of politicians. Using census data and an original job-type classification, Hausermann presents one way to do this. Scaling up Hausermann's attempts to include the wider set of Eurozone economies. The proxy method is not without its problems, particularly in the context of party systems with complex coalition governments. In systems where the link between voter and representative is attenuated by extensive bargaining, as is the case in many of Europe's continental governments, it is unclear to what degree accountability exists between voter and politicians. Such attenuation poses a problem, because the inferential strength of proxying constituent preferences for party and politician preferences relies on accountability as the linking mechanism.

The second inferential problem partially ameliorated by the present empirical framework related to the inferences about the role of the Troika. Recent publications by Ban, Broome, and

Gallagher, demonstrate that understanding how preferences and change within a single organization, the IMF, are complex and difficult to understand. A more thorough study of the role of external actors would more carefully examine preference change within and the policy influence of the European Central Bank and the European Commission. In the present dissertation, the preferences of the European Central Bank are largely treated as static, and the European Commission is treated as a veto point paralyzed by the collective action problem that emerges from a large number of actors, none of which are dominant, that display large variation in preferences.

The recent and emerging literature on the preference change within the IMF describes an important, and often oversimplified, dynamic in understanding policy responses to the 2008 financial crisis. Unlike in response to past financial crises, where a single organization or country dominated the policy response, three separate organizations—the European Commission, the European Central Bank, and the International Monetary Fund—coordinated the response to the financial crisis. To varying extents, each of these organizations maintained independent relationships with both debtor and creditor countries. As Chapter 5 explores, and contrary the conventional wisdom ensconced in the financial press, the Troika did not exist prior to the crisis. Informal and increasingly formal lines of communication only emerged well into the crisis period. As a result, based on the Troika's recent creation and disjointed evolution, it may be more appropriate to treat it as three separate institutions working together on an ad hoc basis. These complex, and to some degree informal, relationships make it difficult to assess which organization drives changes in outcomes. Future research should more carefully consider how preferences change within each of the constituent organizations and how such change drives the policy produced by three organizations with distinct but interrelated goals.

Applications and further research

The present dissertation develops and evaluates the hybrid model in the context of Eurozone economics, politics, and policy. Most obviously, the hybrid model applies to current and future currency unions. However, the hybrid model applies more widely, particularly in the low interest-rate environment that has characterized developed economies since the financial crisis and Japan since the late 1990's. In these countries, central banks responded to the financial crisis and sluggish real conditions by cutting nominal rates, in many cases, to zero. Once at the zero-lower bound (ZLB), at least one of two conditions must be satisfied for the hybrid model to apply: either the country must have a floating exchange rate or, in the case that it does not have a floating regime, a country must have limited foreign-exchange reserves. In the former case, even it has the requisite resources in the form of foreign-exchange reserves, a government has made a commitment not to interfere in foreign-exchange markets; in the latter case, a governments lacks the resources to intervene. Where a government can no longer resort to the conventional monetary policy (as at the ZLB) and cannot displace adjustment externally (by interfering in foreign-exchange markets), a government's situation resembles Eurozone member countries following the financial crisis.

This history of economies with fixed exchange-rate regimes bears important lessons for the applicability of the hybrid model to the Eurozone. Financial-market participants and political observers discuss membership in the Eurozone, once attained, as an exogenous and fixed constraint. For all the talk about the Eurozone as a historically unprecedented institution, from a financial perspective, the union is a group of countries pegged to a single exchange rate, in this case, the Euro. In all probability, Eurozone membership may be treated as fixed in the short-run, particularly in the context of relatively calm financial markets. However, it less clear, and ultimately politically naïve, to treat Eurozone membership as exogenous in the long run. The history of fixed-exchange rate regimes underscores the tremendous political pressure that stems from the economic and financial pressures to displace adjustment outside of the domestic context. While outside the scope of the present study, the negotiations over the third Greek bailout underscore that participation in a currency union is function of endogenous political choices that must be periodically, if not continuously, reaffirmed by domestic political actors. Incorporating such pressures, possibly as a limit condition on the interaction between consonance and the influence of external actors, provides an important next step for the hybrid model in particular and the literature on fiscal-policy reform more broadly.

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